ESTABLISHING A CORPORATION FOR SMALL BUSINESS INVESTMENT (COSBI)

HEARING

BEFORE THE

SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

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ESTABLISHING A CORPORATION FOR SMALL BUSINESS INVESTMENT [COSBI]

WEDNESDAY, DECEMBER 4, 1985

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON SBA AND SBIC AUTHORITY, MINORITY ENTERPRISE AND GENERAL SMALL BUSINESS PROBLEMS, COMMITTEE ON SMALL BUSINESS,

Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Parren J. Mitchell (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN MITCHELL

Mr. MITCHELL. Today we are commencing a hearing on a proposal to create a Corporation for Small Business Investment, and to transfer the Small Business Investment Program currently administered by the Small Business Administration to the corporation.

This concept is embodied in H.R. 3484 [1] which I have introduced along with 37 of my colleagues on the Small Business Committee.

I want to emphasize, however, that we are holding this hearing on the Corporation for Small Business Investment concept, not on the bill itself. The subject matter is very complex and it is hoped that we will not bog down in the details of the bill. I believe instead that we should concentrate on acquiring a thorough knowledge of the basic framework and the industries' views and recommendations on the absolute essentials. Possibly we can then do some redrafting and be in a position to hold hearings early next year on the legislation.

The SBIC and MESBIC Programs have compiled an outstanding record in providing growth capital to small and minority businesses. Over the past 26 years, SBIC's, and MESBIC's have invested more than $6 billion in over 70,000 small firms, thereby providing benefits to the American economy in terms of job creation, business ownership by minority persons, innovative products, and generation of new tax revenues.

Despite their success, however, the stability of these programs is threatened by persistent Federal deficits and the necessity to carefully allocate scarce Federal resources.

The Corporation of Small Business Investment concept would achieve these objectives by establishing a Corporation for Small Business Investment to serve as a financial intermediary to the pri-

[1] See Appendix, p. 33, for the bill H.R. 3484.

vate capital markets for SBIC's and MESBIC's. With an assured source of capital, SBIC's and MESBIC's can make a continuing stream of investments in small firms in search of growth capital. While Corporation of Small Business Investment would be a congressionally sponsored corporation, it would operate as a private sector company, capitalized and managed by the SBIC and MESBIC industries.

Once a Corporation for Small Business Investment is operating, continued authorizations for Federal guarantees of SBIC debentures will no longer be necessary and annual appropriations to support SBIC and MESBIC investment activities also should disappear.

It is my hope that this concept will be found to represent a unique and creative solution to the problem small business continually faces in trying to secure long term investment capital. It is endorsed by the SBIC and MESBIC industries, as well as by many small business organizations.

We are pleased to have with us this morning the chairman of the National Association of Small Business Investment Companies, Thomas Noojin, and Duane Hill, chairman of the American Association of Minority Enterprise Small Business Investment Companies.

Gentlemen, thank you both very much for being here. I would like to receive both of your statements, hear your testimony, and then we will put questions.

Mr. Noojin.

TESTIMONY OF J. THOMAS NOOJIN, CHAIRMAN, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. NOOJIN. Thank you, Mr. Chairman, and members of the subcommittee. We appreciate your scheduling of this historic hearing for our industry on this proposal and the opportunity given us to testify.

I am Thomas Noojin, chairman and president of Hickory Venture Capital Corp., which is located in Huntsville, AL. Hickory is a new SBIC, organized in March of this year as a subsidiary of First Tennessee Bank of Memphis, and capitalized at $4 million. For the 10 years prior to joining Hickory, I was chief executive officer of Invesat Capital Corp., an SBIC in Jackson, MS. I also have the pleasure this year of serving as chairman of the National Association of Small Business Investment Companies, which represents the overwhelming majority of all licensed Small Business Investment Companies.

We very much appreciate your introduction of H.R. 3484, the proposed legislation to create the Corporation for Small Business Investment, and we are elated by the strong bipartisan cosponsorship of 36 members of the Small Business Committee.

At the outset, I would like to make it very clear to the committee that the COSBI proposal has been developed through a joint venture between the MESBIC industry and the SBIC industry. This effort has been a true partnership between the American Association of MESBIC's and NASBIC, in terms of the time, effort, creativity and resources devoted to the development of COSBI. Both organizations fully support this legislation, and I am delighted and hon-

ored to have Duane Hill, the chairman of AAMESBIC, as my fellow witness at this hearing.

Your letter of invitation to testify noted that this hearing would concentrate on the concept of establishing COSBI. The Corporation of Small Business Investment bill is a lengthy and complex piece of legislation, and we certainly agree that the time of the committee will be far better spent by using this first hearing to concentrate on the primary concepts of the proposal, leaving the complex details of the legislation itself for a second hearing.

Accordingly, my testimony today will concentrate on three primary items:

First, why we believe Corporation of Small Business Investment is necessary;

Second, the basic concepts of COSBI and how it will work; and

Third, the benefits COSBI will provide.

Mr. Hill will cover several of these points from the special perspective of the MESBIC industry. Most importantly, he will discuss the special interrelationship of COSBI and the MESBIC industry.

We are proud of the SBIC industry's track record. Our industry has been a major source of venture capital for small business for more than 26 years. SBIC's and MESBIC's have invested more than $6 billion in over 70,000 small growth firms. In 1984 alone, SBIC's made 2,755 investments in a wide variety of small growth companies in geographically diverse sections of the country, while MESBIC's financed 1,087 minority owned small businesses. Today, over 500 SBIC's and MESBIC's, with assets in excess of $2 billion, are actively engaged in the financing of thousands of small, job creating growth companies.

Despite this successful record, however, the SBIC Program has reached a critical crossroads. Let me explain why by giving you a brief review of the industry's recent history.

In retrospect, the 1970's were a dynamic 10 years of SBIC's. The industry's energy was primarily devoted to many positive improvements in the program, including such things as increased leverage, improved compensation plans for SBIC managers, size standard liberalization, limited partnership SBIC's and, of course, an effective system of financing through the Federal Financing Bank. The Small Business Administration's Investment Division staff was generally comprised of experienced individuals and the regulatory environment for the most part, embodied a "let's make it work" approach. I am not suggesting that the seventies were without problems, but the combination of willingness to compromise and leverage availability allowed the industry to undertake its intended mission with a high degree of success.

The industry was on a roll. SBIC assets at cost which had been $633 million in 1970 reached $1.4 billion by 1980. During the decade, the capital gains tax differential had been restored, ERISA had been liberalized to open up pension and other institutional investment in the industry, the economy was beginning to recover from the shock of oil price increases and the number of SBIC's and MESBIC's was dramatically increasing. In addition, Genentech hit the street with a public offering signaling the beginning phases of another euphoric IPO market. The stage was set. A probusiness,

proentrepreneur, procapital formation, no tax increase President had just been elected. What could go wrong?

Unfortunately, the trends established in the seventies did not carry forward into the new decade. The temper of this industry's steel has never been tested as it has during the eighties. At a time when we were poised to continue our leadership position in the venture industry, the administration took away our momentum by stopping leverage and licensing without warning.

A series of Small Business Administration policies initiated during 1981 and 1982 reverberated throughout the Small Business Administration as well as the industry. Budget freezes, retirements, and assumption of program control by individuals with no line experience produced a series of setbacks the industry has yet to recover from. To list a few: When leverage was restored, the Small Business Administration established credit criteria for a theoretical allocation process which happened to fly in the face of 23 years of precedent; the original version of Small Business Administration's overhaul of the SBIC regulations would have devastated the industry; questionable policies prohibiting investments in small operating companies in the oil and gas business; a mandatory equity proposal requiring every SBIC to have investment in straight equity as a percentage of their portfolio; operating agreements for equity oriented SBIC's before they could get leverage, if they could get it at all; a forced investment diversification proposal by SIC code, and there are others. Most of these policies were implemented or initiated without any discussion with the industry, and obviously without any consideration of the operating implications.

The SBIC Program was created by Congress during a period of near balanced budgets when inflation was measured in terms of basis points. As the circumstances have changed, so has the mood of Congress and the administration and the popularity of the Small Business Administration and our program. Attempts to get rid of Small Business Administration did not originate with David Stockman, it has happened before. This administration's effort, however, did come closer to accomplishing that than any in the last 20 years. Fortunately, last year we were able to swing the tide in our favor, due in large part to the extraordinary effort exerted by our supporters in Congress.

Today, however, the political stakes are higher than ever before. The SBIC industry is now controlled by and subject to the political realities of $200 billion deficits. The current mood of the administration, shared by some in Congress, is to eliminate or curtail a broad range of domestic programs regardless of the benefits they produce for the economy and to eliminate any Government-supported programs that are involved in the credit markets. At the same time, the SBIC industry is faced with the fact that Small Business Administration's annual authorization, and the SBIC annual authorization for leverage, are just too small to be a consequential factor in the Federal budget debate. The changes of maintaining a fully functional Small Business Administration and continued leverage availability for the SBIC Program under this scenario, I think, are fairly obvious.

For all of these reasons, we must, as prudent businessmen and women make every effort to privatize the SBIC Program and bring a measure of predictability to our industry. In the face of indisputable success, we are still subject to blind-side, killing blows from Small Business Administration, the administration, and Congress. It is time to alleviate the financial and regulatory uncertainty that makes it impossible to plan our future and protect our capital investments.

In short, because SBIC's are in the business of making long-term investments, they need a reliable partner for the long haul. In order to plan, operate, and invest effectively, SBIC's need a reliable source of long-term funds and a regulatory environment with long-term stability. The current leverage and regulatory process is no longer serving the needs of small business or the SBIC industry. Continued uncertainties of annual congressional funding and restrictive allocations of scarce dollars have made the current financial support process unreliable. In addition, continually changing Government regulatory policies have created an unreliable and unstable operating atmosphere, which is counterproductive to the business of long-term investing.

Let me add the fact that our options are very limited. Funding from the private sector is simply not available to SBIC's under the present design of the program. Unless we have a creative vehicle like COSBI, the SBIC industry's future is in jeopardy.

SBIC's must have access to the capital markets through a financial intermediary that is responsive to the unique needs of Small Business Investment Companies. COSBI will give SBIC's that facility.

COSBI will be a privately owned and managed, special purpose financial institution, created by an act of Congress. Its primary mission will be to provide long-term financing and an effective operating environment for SBIC's.

COSBI will operate as a capital bank, providing SBIC's access to a stable source of leverege. Because of its special status as a Government-sponsored enterprise, COSBI will be able to sell its securities in the capital markets at highly competitive yields. In turn, COSBI will be able to provide leverage to the SBIC industry on terms which are attractive and structured to meet the unique financial needs of SBIC's. This assured source of affordable capital will increase the SBIC industry's capacity to make continued venture capital investments in small growth firms.

In addition, COSBI will exercise oversight of SBIC business practices through a streamlined process that is fair and efficient. COSBI's board and management will respect the SBIC manager's need for long-term policy continuity. This operating environment will be a significant improvement over the current process of Government intervention in SBIC investment activities.

We are confident that COSBI, operating within the risk-reward system of the private marketplace, will generate enormous benefits for the economy in several ways.

Small business will be the primary beneficiary. COSBI will provide small business access to the major capital markets, and we are convinced that COSBI will, in just a few years, increase the flow of

venture capital to small firms by hundreds of millions of dollars, perhaps billions.

Because small business is the major job creator and innovator in the American economy, increased venture investments flowing through the new system will create thousands of new jobs in a wide variety of industries and thousands of product innovations, technologies, and new commercial applications.

We are also convinced that the creation of COSBI will reduce the Federal budget deficit by over $1 billion. The Government will also benefit by the elimination of SBA's complex financial and regulatory apparatus and its accompanying payroll.

In addition, millions of dollars in new tax revenues will be produced by the capital formation multiplier effect of new investments in the economy.

Finally, this country's venture capital system will be greatly enhanced by conversion of the SBIC Program to a fully private system. COSBI will provide a new investment climate that will attract hundreds of millions of dollars of new private capital into the SBIC Program.

COSBI will be a privately owned and managed corporation. In addition, because COSBI will be provided several indicia of Government support, it will be considered a Government-sponsored enterprise. This unique status is similar to that of the Student Loan Marketing Association [SLMA], the Federal National Mortgage Association [FNMA], and several other privately owned corporations supported by the Federal Government. Because of this Government sponsorship, the securities which COSBI issues in the capital markets will receive market acceptance as Federal agency securities, enabling COSBI to obtain favorable interest rates on the funds it borrows. Among the features of Government sponsorship provided in the COSBI bill are the following: COSBI will be a privately owned and managed corporate instrumentality of the United States, created by an act of Congress. The principal office of Corporation of Small Business Investment will be located in Washington, DC.

Initially the President of the United States will appoint an interim five-member board of directors. The main function of the interim board will be to arrange for the initial subscription offering of common stock of COSBI and to take whatever other actions are necessary to proceed with the operation of the Corporation. After $20 million of common stock of COSBI has been purchased, the stockholders will then elect 10 members of the Board of Directors. The remaining five will be appointed by the President.

The common stock and other securities issued by COSBI will be deemed to be exempted securities under the laws administered by the Securities and Exchange Commission, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal and interest by the U.S. Government. No registration statement or other documents with respect to the common stock or other securities issued by COSBI will be required to be filed with the SEC.

COSBI will be exempt from all taxation by any State or by any county, municipal, or local tax authority except for real property

taxes. COSBI will not be exempt from the payment of Federal corporate income tax.

COSBI will be able to conduct its business without regard to any doing business qualification or similar statutes in any State of the United States, including the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

Federally regulated depository institutions will be authorized to make capital contributions to COSBI, and to receive either common or preferred stock evidencing their contributions.

COSBI will be deemed to be an agency of the United States for certain investment purposes, and obligations issued by COSBI will be lawful investments acceptable as security for all fiduciary, trust, and public funds under the authority or control of the United States. With this status, the obligations of COSBI will be considered liquid investments which can be used to satisfy reserve requirements of banks and savings and loan associations.

Upon enactment of the COSBI bill, the President of the United States will appoint an interim Board of Directors, consisting of five members, one of whom will be designated by the President as interim chairman. Of the five members, two will be representatives of small business, two will be representatives of SBIC's and one will be the SBA Administrator. The main function of the interim board will be to arrange for the initial subscription offering of COSBI's common stock and to take other actions necessary to proceed with the operation of the corporation.

After the initial $20 million of common stock has been purchased, COSBI will be managed by a 15-member Board of Directors. The holders of common stock will be entitled to elect 10 members of the Board. The remaining five members will be appointed by the President. One of the five Board members appointed by the President will be representative of MESBIC's.

The Board of Directors will have the responsibility for determining the Corporation's general business, investment, and operating policies. Directors of COSBI will not be considered employees of the Federal Government. The organizers of COSBI anticipate the elected members of COSBI's Board will be experienced SBIC professionals who, as leaders in the industry, will provide balanced representation for all SBIC's, regardless of size or investment policy.

The Board of Directors will also appoint, establish compensation for, and prescribe the functions, powers, and duties of the executive officers selected to manage the day-to-day business operations of COSBI. Officers and staff of COSBI will not be considered employees of the Federal Government. The organizers of COSBI expect that the executive officers selected to manage the Corporation will be qualified individuals who are familiar with the venture capital business and the SBIC industry in particular.

While the specific organizational structure has not been determined, COSBI will be operated as a streamlined, efficient, and cost conscious business organization. In addition, COSBI's management will establish internal systems necessary to the sound operation of a well managed financial institution. These will include audit and finance committees of the Board, internal finance and budgetary control systems, and automated accounting and data systems.

Following enactment of the COSBI bill, the Corporation will undertake a $20 million common stock offering. SBIC's will be offered the right to subscribe, at a subscription price to be determined, a total number of shares of common stock on the basis of 2 percent of the aggregate private capital of the SBIC industry. Accordingly, each SBIC will be offered the right to subscribe a minimum number of shares of common stock on the basis of 2 percent of its private capital.

Proceeds from the proposed subscription of COSBI common stock will be used to provide an equity base to support COSBI's borrowing activities, to provide working capital for COSBI and to carry out general corporate purposes.

COSBI will have access to additional capital based on growth in the SBIC industry. This includes capital contributions by newly organized SBIC's, and supplemental capital contributions from operating SBIC's based on increases in their private capital. In addition, the COSBI bill authorizes the purchase of COSBI's common or preferred stock by Federal depository institutions, and the public sale of COSBI stock. The corporation's decision to utilize these sources of capital external to the SBIC industry will be based on COSBI's performance, consideration of SBIC industry ownership dilution, and other factors.

In order to provide COSBI with the initial asset base of sufficient size to gain recognition in the capital markets, the COSBI bill provides for the sale to COSBI of the portfolio of SBA guaranteed SBIC debentures held by the Federal Financing Bank. The transfer would be made on terms designed to permit COSBI to be self-sustaining and financially sound. As of August 31, 1985, the Federal Financing Bank held SBIC securities guaranteed by the Small Business Administration in the total amount of $1,010,800,000. It is contemplated that COSBI would finance the purchase of the Federal Financing Bank portfolio through the issuance of debt securities in the money and capital markets.

The COSBI bill provides that the Secretary of the Treasury, at his discretion, is authorized to purchase up to $1 billion of obligations issued by COSBI. This authority is similar to discretionary Treasury support provided to FNMA, SLMA, and other Government sponsored enterprises. It is an essential factor in assuring that COSBI's debt instruments achieve market acceptance as Federal agency securities, enabling it to obtain favorable interest rates on those securities. This authority is intended solely as a last resort source of funds for COSBI, and would be used only if absolutely necessary.

COSBI will serve as a secondary market and warehousing facility for loans and investments in SBIC's; will provide liquidity for loans and investments in small business; will stimulate the orderly flow of private equity capital and long term loan funds to small business; and will improve the distribution of investment capital available for small business concerns.

The principal activity of COSBI will consist of the purchase of securities from SBIC's meeting certain eligibility requirements established by the Corporation. The organizers of COSBI fully anticipate the Board of Directors will establish a basic policy that every SBIC, regardless of its size or investment policy, will be eligible for lever-

age if the SBIC's financial condition meets certain minimum qualificaton standards set by COSBI and applied universally to all SBIC's.

It is expected that for some initial period of time COSBI will continue to finance SBIC's through the purchase of long term, fixed rate securities similar to those currently issued through the Federal Financing Bank leverage system. Under the COSBI bill, the Corporation will have authority to finance SBIC's through a variety of sophisticated financial instruments which might more appropriately match the specific liquidity needs of SBIC's. Once COSBI's positive performance record has been shown, its financial condition firmly established and the Corporation's securities have gained acceptance in the money and capital markets, COSBI will broaden its program options and develop customized financial products to meet unique industry requirements.

The investment activities of COSBI will be financed by funds raised in the money and capital markets primarily through the issuance and sale of debt securities. COSBI's debt securities will have market acceptance as Federal agency securities, a category of investments well publicized and known to informed investors. This acceptance will enable COSBI to obtain favorable rate of interest on offerings of its obligations. Notwithstanding their acceptance as Federal agency securities, COSBI's debt securities will not be obligations of the Federal Government and will not be guaranteed by the Federal Government.

COSBI may offer a variety of obligations, including longer maturity debentures, intermediate range debentures, and short term commercial paper, depending on the corporation's financial plans and needs. The debentures and shorter term notes of COSBI will be issued regularly and will be obligations of the corporation. COSBI will also have authority to issue subordinated capital debentures, which would be general obligations of the corporation with no stock conversion provisions. COSBI is also authorized to guaranty securities based on or secured by pools or trusts of SBIC securities eligible for purchase by COSBI. The corporation could be either the issuer of such passthrough securities or act as a guarantor of such securities issued by SBIC's. COSBI may also secure lines of credit through commercial banks which will enable the corporation to satisfy short term borrowing needs, as necessary.

Under the COSBI bill, the corporation is authorized to establish standards of business conduct for SBIC's. COSBI will establish standards of eligibility for newly organized SBIC's to do business with the corporation and standards of business practice for operating SBIC's.

All SBIC's in good standing with SBA at the time the corporation commences operations will automatically be eligible to purchase stock in COSBI and participate in the new program. For newly organized SBIC's, the COSBI bill authorizes the corporation to establish qualification standards to do business with COSBI. Several factors to be included in these standards are specified in the COSBI bill, including the need for the SBIC in its area operations, the probability of its success, adequate capitalization, and qualified management.

The COSBI bill also specifically continues existing authority which permits the purchase of ownership interests in SBIC's by commercial banks, up to an aggregate of 5 percent of the bank's capital and surplus. This authorization is a specific exemption from the Glass-Steagall Act, which generally prohibits banks from engaging in nonbanking related activities.

COSBI will establish standards for sound operating business practices of SBIC's. These standards will include generally accepted operating and reporting requirements expected by creditors in conventional commercial practice. In addition, certain SBIC activities will be specifically prohibited or restricted by the COSBI bill. These include: The prohibition of conflict of interest transactions; a requirement that SBIC's finance only qualified small businesses; a limitation on the dollar amount of an SBIC's investment in any one small firm, based on a percentage of the SBIC's private capital; and limitations on the SBIC's ability to exercise control over any small business it finances.

The SBIC operating standards will be set forth in contractual agreements between COSBI and the SBIC's. Failure of an SBIC to adhere to these criteria will subject the SBIC to suspension or revocation of its qualification to conduct business with COSBI or other appropriate legal action. The contractual agreements will also establish a process by which COSBI will exercise oversight of an SBIC's business practices. This process will be far more efficient than the current Small Business Administration regulatory system. It will include audits, certifications of compliance by independent CPA firms, a timely review of financial reports, civil litigation where necessary, and referrals to the Justice Department in cases involving possible criminal activities.

As a Government-sponsored enterprise, COSBI's business and financial performance will be subject to several forms of review. These oversight features supplement representation on the corporation's board of directors by the five Presidential appointees to the board.

The accounts of COSBI will be audited annually by an independent certified public accountant, and the audit report will be furnished annually to the Secretary of the Treasury, who will have open access to the books and records of the Corporation. In turn, the Secretary of the Treasury will deliver a report of each fiscal year audit of the Corporation investment to the President and the Small Business Committees of the Congress. COSBI also will be required, at the end of each fiscal year, to transmit to the President, the Small Business Committees of the Congress, and the SBA Administrator, a report of its operations and activities for each year.

In addition, the bill provides that COSBI will be subject to audit by the General Accounting Office of the Congress at the request of either of the Small Business Committees of the Congress, as long as COSBI holds, on a Small Business Administration guaranteed basis, the SBIC debenture portfolio acquired from the Federal Financing Bank. Finally, the Small Business Committees of the Congress will retain inherent oversight authority over COSBI as a government supported corporation established under legislative authority of the Small Business Investment Act of 1958.

While COSBI's Board of Directors will have the ultimate authority and responsibility to determine the corporation's investment and operating policies, the organizers of COSBI have developed several key elements of a business strategy for the Corporation which they anticipate will be adopted by the board.

As a for-profit corporation, COSBI's operations should be guided by sound business and financial principles. To successfully fulfill its primary mission as an efficient financial intermediary between SBIC's and the capital and money markets, COSBI must develop and maintain the confidence of the financial community while providing essential financial services to the SBIC industry.

The primary emphasis of COSBI as a newly organized company should be that of building a sound financial base and a reasonable level of profitability. At the same time, COSBI must provide for reasonable growth in activity levels and the development of sufficient services to meet the liquidity needs of SBIC's. In short, COSBI's management should exert every effort to build a strong balance sheet and a strong profit and loss statement.

Accordingly, management must undertake a disciplined approach to building COSBI's capital base. This should include a policy to capitalize retained earnings with no dividend distributions for some initial period of time, as well as positive actions to obtain additional capital without diluting the concept of SBIC-industry ownership. Sources of additional capital would include capital contributions by new SBIC's; supplemental capital contributions resulting from increases in the private capital base of SBIC's; capital contributions from other types of financial institutions; and the possible future public sale of COSBI stock.

Management must exercise care in structuring the terms of its assets and liabilities to reduce COSBI's exposure to future volatility in the bond and money markets. To the extent that COSBI acts as a lending principal, it should place continued stress on obtaining longer maturities at attractive rates, maximize the match between the maturities of its assets and liabilities and minimize short term borrowings.

In providing financial and business practice services to SBIC's, the effective cost to SBIC's for such services should be kept as low as possible, to the extent that goal coincides with COSBI's profitability objectives. This will require a reasonable approach to current income items such as rate spreads, fees, and miscellaneous charges.

COSBI should be operated as a disciplined, cost conscious corporation. This will require the implementation of a system of controls and procedures designed to enhance efficiency and cost control.

COSBI should take a measured approach to expanding its menu of products. It may be appropriate for the first several years to continue financing SBIC's through the familiar medium of long term, fixed rate securities. Once COSBI has established a firm financial base and has gained clear recognition in the capital markets, it can broaden its program options and develop tailored products to meet specific capital needs of SBIC's.

The vast majority of SBIC's have operated in strict conformity with the rules governing the program. Exceptional cases of unjust self-enrichment, fraud, or abusive regulatory activities have

harmed the industry's image and caused financial losses. COSBI's management must exercise extreme care to assure such abuses do not occur. This will require strict adherence to standards of entry, diligent oversight, and efficient enforcement of standards of business conduct. We believe that H.R. 3484 provides COSBI with the authority to pursue vigorously any abuses.

The COSBI bill provides for a transition from Small Business Administration to COSBI programs. COSBI will be established upon enactment of the legislation, and the interim board will undertake the common stock offering and other necessary corporate activities. During this period, Small Business Administration programs will continue to operate. When COSBI has raised its initial capital and is prepared to begin its loan and investment operations, but not later than 1 year after enactment of the bill, SBA's programs will terminate and COSBI will become fully operational.

Mr. Chairman, and members of the subcommittee, I wish to conclude by stating that we believe that COSBI represents a bold, even historic, step for our industry. Over the past 26 years, SBIC's and MESBIC's have built an impressive record of developing the Nation's most job generating and innovative small businesses. But now the industry is at a critical crossroads that will determine its future and the future of many small firms our industry is designed to assist.

Under COSBI, SBIC's and MESBIC's will assume the risks of operating in the private marketplace in return for the chance to eliminate the chronic problems which limit our effectiveness. Both NASBIC and AAMESBIC, and our member companies, are convinced that if COSBI becomes a reality, everyone will be a winner.

Small business historically has been foreclosed from access to the major capital markets. Under COSBI the private marketplace will provide hundreds of millions of dollars for venture capital investments in small firms. The impact of these investments on our economy will be enormous in terms of the kinds of job creation, new products, and increased innovation that only small business can produce.

In addition, the Federal Government will benefit from a deficit reduction in excess of $1 billion; increased tax revenues produced from the profits, operations and employment of small growth firms, and a streamlined Government agency.

Finally, we would hope that our industry would experience significant growth under COSBI, to the ultimate benefit of the American economy.

COSBI was developed over the past 2 years, with considerable industry input and counsel and advice from experts in the capital markets. We are convinced that the Corporation represents a dramatic structural redesign of the SBIC Program that will work.

We urge your favorable consideration of our COSBI proposal, and we look forward to a subsequent hearing to resolve any detailed issues related to the legislation.

This concludes my prepared statement, Mr. Chairman. I will be pleased to respond to any questions from the subcommittee. Thank you.

I will now turn it over to Duane Hill.

Mr. MITCHELL. Before you proceed, Mr. Hill, let me tell you that was just excellent, thorough analytical testimony. We appreciate the thoroughness of your presentation.

Mr. Hill.

TESTIMONY OF DUANE HILL, CHAIRMAN, AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES

Mr. HILL. Thank you. Good morning, Mr. Chairman, and members of the subcommittee. I am Duane Hill, president of Equico Capital Corp. in New York, and chairman of the American Association of Minority Enterprise Small Business Investment Companies.

As president of Equico, I direct the activities of the largest investment company in the MESBIC industry. Equico Capital Corp. is a subsidiary of the Equitable Life Assurance Society of the United States. Since its establishment in 1971, Equico has made investments in a broad range of industries including manufacturing, distribution, retail, service, and communications companies throughout the United States. With a private capital base of over $10 million, we not only make direct investments in minority owned small businesses, but we also form syndications for larger investments and enable our clients to support further borrowing from senior lenders.

Equico was one of the first MESBIC's established after the industry's formation. As such, we have seen many changes taking place through the years. The MESBIC industry was first established in the late sixties. Using the small business investment company industry as a model, the Nixon administration approached several large U.S. private institutions for investment capital for minority small businesses. In turn, the Government would provide matching funds for minority investment. Thus, corporate America and the U.S. Government would join together in a partnership to promote the participation of minorities in the U.S. economic system.

In 1971, the first year for which MESBIC investment figures are available, MESBIC's invested $2.2 million, with an average investment figure of less than $13,000. By 1984, MESBIC's had reached an annual investment figure of $88.5 million, with the majority of our deals at over $100,000. Obviously we have come a long way in our short history. We have become more adept as investors in discerning those minority entrepreneurs and small businesses which have the best opportunity to succeed.

Our investments today are much larger than they were in the early days, and the entrepreneurs more sophisticated. Many of our investments are in consortium deals, drawing additional private dollars to the minority small business community. In addition, these successful entrepreneurs are providing important employment and management training opportunities to other minorities.

Examples of our success stories include Chicken George, Inc., whose president testified before the House Small Business Committee in April. Chicken George is a Baltimore based fast food restaurant chain which employs over 500 people and has a projected revenue figure of $12 million for next year.

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In New York, MESBIC's provided early stage financing to Essence magazine. Essence now has a circulation of 800,000 and advertising revenues of $11 million.

In Illinois, several minority owned, multistore franchise owners of McDonald's, Burger King, and Popeyes all received their initial capital for their first operations from a MESBIC.

Among our Hispanic deals we list Ninfa's, Inc., a chain of Mexican restaurants which ranked 70th on the 1985 Hispanic Business 500. We also invested in Digitron Tool Co., a tool and die machining company which ranked 85th on the Hispanic Business 500. Digitron, which was started by 2 Cuban refugees in 1977, now employs 250 people and had 1984 sales of $15.5 million.

Finally, in California, the industry invested in X-Ten Corp., a Chinese owned startup company which designed an extendable versachassis capable of handling all size containers efficiently. This product has revolutionized the transportation industry.

Today's hearing addresses H.R. 3484, a bill to create the Corporation for Small Business Investment. H.R. 3484 represents the culmination of extensive work on the part of the MESBIC and SBIC industries, public policymakers, and Wall Street analysts. All of these parties worked together to develop a bill to establish the Corporation for Small Business Investment. They envisioned COSBI as the most effective approach to combine Government efforts to foster small business development, and its resultant job creation and innovation, with the increased access to private capital and stability an institution such as COSBI would provide.

As a Government sponsored, privately owned entity, the Corporation would be similar to other agencies established in the past to achieve certain public policy goals, such as the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association, which were developed to promote home ownership. Similar to these agencies, COSBI would issue securities to finance its lending operations. This loan pooling, combined with COSBI's U.S. agency status and a U.S. Treasury backstop of $1 billion, would enable the MESBIC and SBIC industries to gain access to private capital markets at an affordable rate.

At the same time COSBI is expected to provide increased access to private capital, it will also provide many other advantages. The increased privatization of the MESBIC and SBIC industries should be advantageous to both the Government and industry members. Our move from the annual appropriations process to an agency issuing securities on the market will eliminate Federal outlays at the same time it provides a more stable funding source for the continued growth of the industry.

Funding stability has been a particularly problematic concern for the MESBIC industry over the past several years. In the industry's early years, there was an abundance of leverage money available. Unfortunately, the MESBIC leverage applications in recent years have significantly exceeded the available capital. MESBIC's are required to have invested at least 65 percent of their private capital before they become eligible to apply for leverage. Even those companies which fulfill all the leverage requirements must wait months to obtain their leverage. Each new quarter's leverage funds are released to fill the preceding quarter's backlog. This is true, al-

though the industry, which has a potential Government leverage ratio of 4:1, is presently leveraged only at 1:1.

But fund shortages sometimes seem to be the least of our worries. More than once in the recent past, the very existence of the industry has been threatened. In 1981, we were completely eliminated from the budget through an "oversight" of the Senate Budget Committee. It took months of hard work to reinstate the program funds in the budget. Four years later, in 1985, we were endangered once again when the administration proposed elimination of the Small Business Administration.

The MESBIC industry has grown extensively under the auspices of the Small Business Administration. In fact, a recent preliminary GAO review on the industry questioned the Government's ability to continue to meet the growing financial needs of the industry. The Small Business Administration is to be commended for bringing us through our early years to this crossroads. We see it making similar accomplishments with its other programs. It is exactly because of the Small Business Administration's success at fostering new small business programs that the MESBIC industry should now move to the Corporation for Small Business Investment. The move would augment other Small Business Administration programs and services to small businesses, while addressing the industry's future financial needs.

As the next stage in a natural growth process, COSBI would be complementary to SBA. Although COSBI would be a private institution, it would continue an important public policy role through its augmentation of Small Business Administration programs serving the needs of small businesses. By bringing SBIC and MESBIC securities to the market, our access to capital in the long run would be determined by our success as investors, rather than the appropriations process.

In every possible sense, it is a proposal to maintain the positive aspects of the SBIC and MESBIC Programs while moving further toward the industry's privatization.

In addition to providing funding stability, COSBI would provide other advantages. It would provide increased visibility for the SBIC and MESBIC industries. This in turn, could be a catalyst to attracting new capital to small business investments. COSBI, which will be discussed in more detail later in my statement, will adhere to a free market philosophy.

Finally, through providing increased access to private capital, the Corporation will achieve important public policy goals at a minimal expense to the Government. Small businesses are the major source of new jobs and innovations. MESBIC portfolio investments in 1984 helped to create or maintain over 14,000 jobs. These positions often offered valuable management training opportunities to minorities.

Our investments also help minorities to enter and compete in high technology areas. In fact, the MESBIC industry has invested in 75 percent of the minority owned communications projects in the country. Thus, by helping to establish the Corporation for Small Business Investment, Congress would be achieving the important public policy objectives of promoting job creation and innovation in the majority and minority communities.

There are four major areas in which the Small Business Administration presently regulates the SBIC and MESBIC industries: Management, funding, licensing, and monitoring/auditing. COSBI will replace the Small Business Administration regulation of these areas in what we believe will be an efficient and effective manner.

Under the COSBI proposal, immediately after it is established, COSBI will be managed by an interim Board of Directors appointed by the President. The Board will consist of two representatives of the SBIC industry, two small business representatives, and the Small Business Administration Administrator. This Board will be responsible for arranging COSBI's initial $20 million stock offering, which will be raised by the SBIC and MESBIC licensees.

Once the $20 million stock offering is completed, a permanent Board will replace the interim board. The permanent Board will consist of 15 members. Ten of these members will be elected by stockholders through cumulative voting rights. The other five members will be appointed by the President, with at least one coming from the MESBIC industry.

At this point, I would like to stress the importance of MESBIC representation on the Board of Directors. It is absolutely essential to our support for the Corporation. One of the most important topics discussed at regional meetings that AAMESBIC has held concerning COSBI was industry representation of the Corporation's governing Board. We believe such representation is necessary to ensure balanced discussions on issues of policy within the corporation.

As for the 10 elected Board members, because they will be elected by corporation stockholders, it is expected that they will come from among the leadership of the SBIC and MESBIC industries. As such, they would bring to their positions years of experience in the venture capital industry. This experience will help them in their roles as policy makers for COSBI.

The five politically appointed Board members will ensure that the Board continues to set as high priorities the public policy goals for which the Corporation is being established. In a sense, the makeup of the Board will serve to create a system of checks and balances which will result in the pursuance of these goals in the most efficient manner possible.

In addition, COSBI will have the responsibility of submitting an annual report and audit to the Treasury, the President, the Small Business Administration, and the House and Senate Small Business Committees.

The funding process for SBIC's has a history of instability. As you have already heard from both NASBIC's and our testimony, not only the amount but the very existence of funds is often questionable. COSBI would provide a stable source of funds to the SBIC and MESBIC industries and allow our investment companies to make long term investment decisions.

The SBIC and MESBIC industries would be responsible for providing the initial capitalization of the Corporation. All operating companies would invest 2 percent of our private capital in the Corporation's common stock, producing a total initial capital pool of $20 million. Our industries are willing to face this risk because we believe the funding stability and other benefits we will receive from the Corporation will be worth the risk in the long run.

Funding for the MESBIC Program now is completely on budget and must be appropriated each year. MESBIC funds may take one of two forms—long-term debentures similar to those for regular SBIC's, but with a 3-percent interest rate subsidy for the first 5 years, and Small Business Administration purchases of preferred stock issued by MESBIC's. The stock carries a 3-percent cumulative dividend. Both the temporary subsidy on debentures and the preferred stock purchases are available only to MESBIC's and not regular SBIC's. These additional provisions are offered to the MESBIC industry in recognition of the additional restrictions placed on our class of eligible investments and the resultant higher level of risk we incur.

Under COSBI, MESBIC's would continue to have the options of both subsidized debentures and preferred stock offerings. A MESBIC trust would be established to fill this purpose. All of the outstanding MESBIC debentures and preferred securities in SBA's portfolio will be transferred to COSBI, to be held in a liquidating trust for a period of 50 years. These securities would be combined with a one-time budget appropriation of $100 million to form the trust. Over the years, any interest paid on MESBIC loans, dividends on preferred stock and proceeds from debenture repayments and retired preferred stock will be added to the assets of the trust.

The trust funds will be used for several purposes. One of the uses will be to cover any losses on COSBI loans or investments to MESBIC's. Thus, the fund should make MESBIC participation in the Corporation very attractive from a market standpoint, by offering this added protection on investments.

Another use of the funds will be to provide the interest rate differential on debentures issued by MESBIC's and purchased by COSBI. Thus, a MESBIC debenture to the Corporation would pay an interest rate on the debentures 3-percent lower than regular SBIC's for the first 5 years of the life of the debenture. The difference would be paid by the trust to COSBI.

A third use of the trust funds would be to purchase preferred stock issued by MESBIC's. The trust is the only source of funds for this purpose. In the past, the issuance of preferred stock has been a very important source of investment capital to the MESBIC industry.

A final use of the funds would be to cover the operating costs of the trust.

In essence, for a period of 50 years these MESBIC assets will be used as a self-sustaining asset base to provide the financial incentives for the MESBIC Program. Conversely, if these assets do not produce sufficient income, the rate differential on debentures and the option of issuing preferred stock would no longer be available to MESBIC's.

At the end of the 50-year period, the liquidating trust will terminate, and any outstanding preferred stock and dividends held by COSBI will be transferred to the U.S. Treasury. After that date, the financial incentives for MESBIC's will terminate and MESBIC's will operate as regular SBIC's.

Administration of the trust will be separate from that of the Corporation. The trust will be administered by five trustees appointed by the Board of COSBI, with at least three of the five coming from

the MESBIC industry. The Corporation will establish separate accounting for the trust and the trust-related MESBIC debentures purchased by the Corporation, and will provide an annual accounting of trust operations to the Secretary of the Treasury.

The trust represents a relatively small Government outlay to achieve significant results toward public policy goals. The one-time appropriation, which represents less than 2½ years appropriations to MESBIC's at our current level, is expected to sustain the special incentives for minority investments and job creation for a full 50 years.

In addition, the trust's coverage of any losses COSBI might incur on MESBIC debentures would make the Corporation a more attractive market opportunity. This would, in turn, lead to increased access to capital markets for the SBIC industry as a whole. Thus, the one-time appropriation of $100 million would lead to increased small business investment, job creation, and innovation in both the minority and majority communities.

There are several requirements for obtaining a license to operate as a small business investment company. Chief among these are the capitalization level of at least $1 million, the requirement of a State charter, and specific standards on management expertise. This restriction of entry into the industry was designed to protect the Government dollars that go into the program.

COSBI is designed to provide similar protection of investments in the Corporation. The Corporation would replace SBA's licensing system with contractual agreements between the Corporation and the SBIC's. New SBIC and MESBIC's would have to meet criteria similar to those presently used by the Small Business Administration. COSBI will have the authority to suspend or terminate the contracts of SBIC's found to be in breach of those contracts. The contractual arrangement is also expected to be more expedient than the present licensing process. Thus, COSBI licensing is expected to provide the same advantages of the present system, with a shorter time requirement.

The Small Business Administration monitors the MESBIC industry through its report filing requirements. MESBIC's must submit year end audited financial statements, annual portfolio information forms, and portfolio financing forms after each investment transaction. Additionally, the Small Business Administration conducts annual audits of each MESBIC's investments and activities. The purpose of these monitoring activities is to ensure that all licensees are operating in cooperation with the Small Business Investment Act and the rules and regulations pertaining to the act.

Under COSBI, licensees will be required by their contractual agreements with the Corporation to submit to audits by the Corporation to assure compliance with its requirements. In addition, Small Business Administration regulations that an independent external audit be conducted will not change.

As I mentioned earlier, the Corporation will be required to submit an annual report on its activities to the Small Business Administration, the President, and the House and Senate Small Business Committees. In addition, an annual audit of the Corporation, performed by a certified public accountant, must be supplied to the Treasury, the President, the Small Business Administration, and

the Small Business Committees, which will maintain oversight responsibilities.

In summary, COSBI provides many mechanisms for monitoring the MESBIC and SBIC industry members to ensure that they continue to operate in accordance with the Small Business Investment Act.

In summary, COSBI regulation of the MESBIC industry is expected to offer many benefits of Government regulation in addition to many new benefits. The combined shareholder elected/Presidential appointed board will offer venture capital experience and public interest representation. The stability of funds is expected to be improved by removing the industry from its reliance on the annual appropriations process. A licensing process and monitoring and auditing functions have been developed for the corporation that will continue to serve the public policy goals achieved by the Small Business Administration regulation of the industry, while fitting in to the private sector functions of the corporation.

As a result of these changes, the small business investment company industry, and the small businesses in which it invests, will be better served. MESBIC's will operate in a more stable regulatory environment with greater access to capital markets through a financial intermediary designed to meet the unique needs of SBIC's. COSBI will provide access for small businesses to the major capital markets, increasing the flow of capital to small businesses by many hundreds of millions of dollars per year.

I thank you for this opportunity to testify before your subcommittee.

Mr. MITCHELL. Thank you. Yours, too, was just excellent and exhaustive testimony.

Members of the subcommittee, this is perhaps the most complex piece of legislation that we will consider. For that reason, I will go last in questioning, because I have a series of questions I want to make sure there are answers for the record, because of the complexity of the legislation, and I will go last in case some of the others have meetings to attend or other things.

But I would suggest, because of the smallness of our numbers, we can allow up to 10 minutes for each question period per person, if you need that amount of time.

Mr. TORRES. Thank you, Mr. Chairman.

I, too, want to welcome the two gentlemen that are here this morning, and elaborate on what I think is a very unique and exciting piece of legislation that will be before us. I think in terms of our statement, Mr. Chairman, I would like to indicate that one of the biggest issues that we face today is the Federal budget reduction. I think this is one of the issues that will be confronted when this legislation approached the floor of the House.

I want to ask a very salient question. I hope it will satisfy many of the inquiries and concerns that other members have, and that is, at least in passing in the testimony by Mr. Noojin, he stated at least on two occasions that COSBI will affect the reduction of the Federal budget deficit by some $1 billion. I think it is important to understand how this will happen again for the record. Can you elaborate further on that?

Mr. NOOJIN. Yes; at the present time, the SBIC's and MESBIC's sell debentures through the Federal Financing Bank, which are 100-percent guaranteed by the Small Business Administration. It is my understanding under the new budget concept, that Federal Financing Bank financing will be included in the budget for the first time. By taking the appropriations out, by COSBI purchasing those assets, it will have the immediate effect of reducing the obligations on the Government balance sheet by approximately $1 billion.

Mr. TORRES. You mentioned also, I didn't quite catch the inferences, some other point of how that might also be.

Mr. NOOJIN. At the present time, SBIC's and MESBIC's, subject to the reconciliation process that is currently under way, have authorized approximately $250 million per year for the next 3 years for SBIC's and approximately $45 million a year for MESBIC's for the next 3 years. That will obviously be eliminated if COSBI is passed and the result will be a savings of approximately $900 million.

Mr. TORRES. Thank you.

Mr. MITCHELL. Mr. Dreier.

Mr. DREIER. Thank you very much.

I, too, would like to congratulate the witnesses, both of them, on their fine testimony.

I would like to thank you, Mr. Chairman, for calling this hearing so expeditiously. I can only assume that the speed with which you called the hearing also will indicate the speed with which we plan to move this legislation. I read last night several pieces of information that were put out in special bulletins from NASBIC and some of the AAMESBIC information. I have to say that the second paragraph of the first special bulletin looks to me as if COSBI is the panacea to all the ailments of society.

I was very impressed. This second paragraph says:

> The legislation will provide enormous public benefits by increasing the flow of private capital to small business, generating thousands of new jobs in a wide variety of industries, reducing the Federal deficit by $1 billion, producing $1 billion of new tax revenues, stimulating product innovation and new technology, and eliminating a complex financial regulatory system now operated by the Government.

It sounds absolutely terrific and you have both very eloquently outlined the thing which is of greatest concern to me, and that is the uncertainty as it relates to both the appropriations process and the regulatory burden. I believe that it looks as if there are great prospects for changes in that regulatory burden and stabilizing, as you point out, the uncertainties of the appropriations and funding process.

What I would like to know is if there are any other adverse constraints which both programs, being associated with the Small Business Administration, have been directly due to Small Business Administration involvement?

Mr. NOOJIN. Shall I answer it first?

There are a number of adversities, primarily in the changing policy of the Small Business Administration as administrations change. At certain times the focus of the SBA has not been consistent. I can give specific examples. It is primarily from a change in regulatory emphasis that has created problems for the industry.

In addition, since 1981 Congress has consistently reduced the Small Business Administration's budget, I believe 72 percent thus far, and it is scheduled to go down another 27 percent over the next 3 years.

There have been a number of early retirements and budget freezes at the Small Business Administration. Morale at SBA has been the lowest I have seen it in the last 17 years. This has led to disruptions in licensing and a changing focus in the regulatory process.

But the most critical thing, Mr. Dreier, the most critical thing is due to the budget constraints. The availability of leverage is the life blood of the industry, that is, leverage has been stifled and the emphasis has been changed. For example, companies that have been operating for several years, and have made long term investments, 5 to 10 years—on the basis of what the industry was supposed to do, and on the basis of what the regulatory process has been, wake up and overnight find out that is no longer a priority.

For example, emphasis was given to equity-oriented SBIC's and MESBIC's because equity investments, and not loans, are supposedly what small business needs. As a matter of fact, as of last year approximately 50 percent of the dollars disbursed by the combined industries were equity securities as opposed to debt securities. We have had companies 100 percent equity invested, finding out on the basis of an arbitrary policy decision with no notice procedure that they are no longer eligible for leverage because they are doing what the program was designed to do, that is, put out equity. It is these inconsistencies that are the problems with the Small Business Administration.

Mr. DREIER. Would you see those as continuing down the road if there is a continued association with the Small Business Administration?

Mr. NOOJIN. History would indicate that that would be the case, Mr. Dreier.

Mr. DREIER. Mr. Hill.

Mr. HILL. I would echo Tom's comments. I think basically it can be summed up by saying that there is clearly a regulatory lag. I think the world changes and the SBIC and MESBIC industries have changed and I think because of the limited resources that are available at the Small Business Administration, they simply have not been able to keep up, and there has been that regulatory lag in not allowing us to continue to operate the industry in a stable fashion.

Mr. DREIER. Do you both believe that the consistency of the proposed regulations which you have outlined, some being tougher, some being less tough, will have an overall benefit for the industry itself.

Mr. NOOJIN. I don't think there is any question about it. For example, I think the entrance requirements or the standard that could be established by a private corporation for establishment of an SBIC could be much more rigid and much tougher, something the industry has advocated for years. We would contemplate increasing the capital requirements, and increasing the background experience and education requirements for licensees above those that presently exist.

As to the regulatory process, we would intend to focus on the mission and objectives of the program and utilize standard or traditional methods for controlling the nonpolicy objectives such as GAAP accounting, for example, as opposed to a separate set of books for the Small Business Administration.

Mr. DREIER. Go ahead.

Mr. HILL. I was going to comment, it is important to recognize that COSBI, SBIC's, and MESBIC's will be in the marketplace. I think the kind of discipline that the marketplace imposes will be very beneficial to the industry. I think we, as businessmen, understand if we are going to continue to access capital from the marketplace, that Corporation for Small Business Investment will have to run in a very sound and pragmatic and particularly sound financial fashion. I think the marketplace discipline imposed will certainly be good for the industry.

Mr. DREIER. That is a good answer. We are sitting here today in large part because of tax reform, which is being considered in Congress. We had a scheduled adjournment date for this session of Congress of November 1, and while we all wanted to move this legislation, hold this hearing, we are here in large part because tax reform is being considered by the House of Representatives.

I would like to know from both of you, what impact you think that—and who knows exactly what the tax reform bill will consist of, I certainly don't—but as you have looked at the different provisions of the tax reform measure, which has been reported out of the House Ways and Means Committee, what impact do you believe it will have first on the SBIC industry, and second, on this proposal for a Corporation for Small Business Investment?

Mr. NOOJIN. I think that based on what I know of what has been reported out, the corporate capital gains tax provisions will have a very negative effect specifically on the SBIC industry, primarily due to the fact that most SBIC's are in corporate form and most of the sources of private funding for SBIC's are from corporations. That also applies to the venture capital community.

In terms of COSBI, I don't think it will have a direct effect per se, but the capital raising process for SBIC's will obviously affect the capital raising process for COSBI.

Mr. HILL. I am not sure I have anything to add to that.

Mr. DREIER. Thank you very much.

Mr. MITCHELL. Thank you.

Congressman Hayes.

Mr. HAYES. Thank you, Mr. Chairman.

Mr. MITCHELL. You are recognized for 10 minutes, if you so desire.

Mr. HAYES. I am certainly not going to infringe upon the time that may be necessary for you to raise the kinds of questions that you want to raise. I don't think I will use 10 minutes.

I am sorry I missed the testimony of the first witness, but I found out you have to divide yourself sometimes in two places at the same time almost, particularly when it comes to committee hearings.

I just left a committee where they have been discussing an important issue with me, drug abuse and alcoholism, and I rushed to

get here because I was interested in the issue which is before this committee, which I am a part of.

I was very impressed, Mr. Hill, with that part of your testimony which I heard. The success that you personally have achieved obviously comes as a result of several reasons, particularly your own academic background. You must be amply prepared to deal with the subject of distribution of money.

I come from that section of our society in which the prime concern has always been in the area of the employees, their being able to live in human decency and not so much in the area of entrepreneurship. But I learned since I have been a part of this committee, and traveled with my chairman, who you know is leaving us—I wish he wouldn't, but I can't do anything about that—but I have learned that particularly when it comes to minorities, the jobs, there is a direct correlation between jobs and small business. The dependency on jobs in my area, particularly in Chicago, comes from small business, and their survival is important at a time when chapter 11 and bankruptcies of all sorts are quite prevalent.

Cleaning establishments, a laundromat, we have got folding filling stations in the community being taken over by some of the big oil companies, you know, and they are forced to operate based on their rules, or go out of business. With that is the elimination of certain jobs. You can't hardly find a place in my area to get your oil changed. You must now do it yourself.

This is the kind of thing that concerns me. You represent to me, as I noticed on the list, two separate entities, both concerned with small business. We are living in an era of consolidation of business—not emphasis on small business but big business, so to speak. I have never seen so many mergers and combinations and sales of stock and this kind of thing out of which some people reach such great rewards. I am sure you are as alarmed as I am when the vice president of General Dynamics, a company which I am most familiar with, or Beatrice Foods can retire and come back for 4 months and reap severance pay of some $7 million at a time when we can't pass a bill in this Congress to notify a working person 90 days in advance he is going to be out of a job. There is something wrong with that.

I am wondering if the big money, that is, the institutions, if you notice any resistance on their part to the formation of COSBI? I notice what is happening to the State-operated savings and loans associations, is that they have been forced out, too. Do you have support, are they lobbying, for example, behind the scenes against the passage of the bill which is before us that we are talking about now, which would lead to the formation of the Corporation for Small Business Investment?

Mr. HILL. First, Congressman, let me thank you for your very kind remarks.

In answer to your question, I don't know that I have detected any resistance on the part of major corporations. I would think they would be supportive.

Mr. HAYES. They aren't looking for competition in the money lending business?

Mr. HILL. That may be the case. I don't know that we would necessarily represent competition. I think, as indicated, one of the

things many of the major corporations, many have been sponsors of MESBIC's—Equitable, of course Sears out in Chicago, Amoco in particular has been very supportive of their MESBIC and very active. I think what COSBI will provide is an assurance that the program is going to be around, will reduce that uncertainty about future funding, and so I would think they would be pleased with that and hopefully that will encourage them to invest more capital.

I think with the growth and sophistication and greater success of the MESBIC industry we would hope that, along with the Corporation for Small Business Investment we would attract more capital from some of the major corporations.

Mr. NOOJIN. Mr. Hayes, we are not aware of any resistance at the present time from institutional sources outside the Government, against the formation of Corporation for Small Business Investment. I might add that the chamber of commerce, which is traditionally a big business organization, has fully endorsed the concept, as has the National Federation of Independent Businesses. And to address one other issue that you alluded to, one of the trends in the venture capital industry at the present time is corporate partnership with venture companies.

Big business is emphasizing the necessity for entrepreneurial units, the most glowing success being the IBM PC project, which was set up as a separate entrepreneurial unit in a $20 billion corporation and told to do whatever they wanted to do.

General Motors, for example, has invested $50 million in machine vision companies, none of which has as much as $5 million in revenues, just in the last 15 months because they realized that this advanced technology arena can only be properly exploited in the small entrepreneurial environment.

So this trend is having a very positive effect on our industry as a matter of fact, and I do not see major corporation consolidations stifling entrepreneurship.

Mr. HAYES. I want to make one final comment. You are aware of the fact that I am not opposed to technological change, it is here, it is the age we are living in and it has been accepted for what it is worth. It has left in its wake many unemployed people, a lot of whom are in my district, particularly. It is becoming more and more of a concern of mine that small business survivors take up some of the slack if the people are to be retrained to do other things and place them in jobs that are not there now.

I am in favor of the legislation that is being proposed but I do hope that it does what it is purported to do—provide employment for people who are out of work and want to work.

Thank you very much, Mr. Chairman.

Mr. MITCHELL. Thank you.

I just want to make one observation, then I want to get into a series of questions that the staff has prepared because I think it is very important that we have those questions answered for the record as part of this hearing. My observation is that I winced a little bit when I heard mention of more strict standards, because going back to my earlier association with MESBIC's and with SBIC's, you will remember that was one of my harping criticisms at one time: That both entities were a little too stringent and

therefore you weren't making the kind of loans that I thought should be made.

That has changed significantly. Now please understand me, I have no quarrel for stricter standards for entry, for a new SBIC or new MESBIC. I have no quarrel with that, although I would have concern if indeed some regulations come down governing those new entries or all the entries making standards so tight that we will preclude a large number of firms from accessing to this capital.

In short, I don't want you to take the strictest bankers attitudes and requirements, because there has to be an element of risk. We want to minimize the risk, which you have done very successfully. On the other hand, I just have a concern that in the lending portion or the investment portion of the operation you set standards so high you really preclude your own effectiveness. I am talking about the investments themselves.

Mr. Noojin, on page 6, you noted that COSBI will be able to sell securities in the capital market in a highly competitive field. What is the estimated interest rate on debentures sold to private investors by the Corporation for Small Business Investment compared to those now sold by the Small Business Administration?

Mr. NOOJIN. Approximately 50 to 100 basis points higher.

Mr. MITCHELL. The Small Business Administration is 50 to 100 points higher?

Mr. NOOJIN. No sir, the new ones would be.

Mr. MITCHELL. Fifty to one hundred points higher?

Mr. NOOJIN. Yes sir.

Mr. MITCHELL. Now, you indicated that stock and other securities issued by COSBI will be deemed as exempted securities. Since the Small Business Administration will no longer be involved and the only agency audit might be by GAO, what is going to take the place of the protection accorded by the SEC, the Securities and Exchange Commission?

Mr. NOOJIN. Well, this is not dissimilar from what the mortgage industry went through, for example, with Fannie Mae. The stockholders are anticipated to be the industry—MESBIC's and SBIC's initially at least. This is where the securities exemption comes into play. If there are offerings, I don't suggest that the normal disclosure requirements and antifraud provisions would not come into play because they certainly would. The exemption is from the registration requirements, and the reporting requirements to the SEC to facilitate the issue, but there will be reporting requirements to Congress, and to the Department of the Treasury; and an outside independent audit would be conducted of COSBI itself. Am I addressing your specific point?

Mr. MITCHELL. Yes; let me make sure I am understanding you. You are saying that because of the zeal with which the entire COSBI operation will be monitored, audited and so forth, that process itself would be sufficient for the protection of investors no longer being involved with that kind of SEC protection? Are you saying just the rigorous implementation of this program will be the protection for the investors?

Mr. NOOJIN. I do not envision a situation where full arms-length disclosure, which is the function of the SEC, will not be the case. In terms of investor protection, I think once the Corporation is orga-

nized, that the fiduciary obligation of the directors and officers of the Corporation will be that of any other private corporation. In terms of the initial stock offering, I envision that as being fairly straightforward. We are not dealing with an historical entity here, we are dealing with the precedent, however, of other Government-sponsored enterprises.

So I don't think that the kind of rigorous oversight and examination normally attached to Securities and Exchange Commission registrations and offerings is necessary in this instance. It will be a private offering to sophisticated institutions, as opposed to unsophisticated individuals that are normally nonaccredited investors which the SEC normally associates itself with.

Mr. MITCHELL. I follow you. You understand why I am a little skittish. We have had problems with S&L's in my State of Maryland, we have had problems with other financial institutions, in dealing with the Government in terms of the protection of investors. I am satisfied with your response.

You have a permanent Board of Directors of 15 persons, 10 selected by the stockholders and 5 appointed by the President. This Board, it seems to me, will be in place prior to the payment to the Government for the outstanding portfolio of the SBIC's. Why should not the Federal Government retain control of the Board? Am I making myself clear? You have a situation in which you are going to put your Board in place, that Board will be in place before you pay for the outstanding portfolio and actually you will set up a situation in which the Government, the Federal Government, to whom that money is owed, really has no representation on the Board.

Mr. NOOJIN. At formation, Mr. Chairman, the Government will be paid those moneys. In other words, the securities will be purchased from the Federal Financing Bank at the formation.

Mr. MITCHELL. Prior to your finalization of the Board?

Mr. NOOJIN. Simultaneous with the finalization of the Board.

Once the Corporation is formed, it will go to the street and raise the capital to purchase the securities from the Federal Financing Bank. So their direct obligation will be eliminated upon formation of COSBI.

Mr. MITCHELL. All right.

Mr. HILL. I think, Mr. Chairman, the key issue there is one of accountability and I think the Board, whether it is a board composed of a government or whomever, will be accountable. I think this is the key. We, as small business investment companies and MESBIC's invest in institutions all the time that we don't control but that accountability is vested in a board of directors that represents the interests of the shareholders and the creditors association that I think the accountability of the directors and the fact that they are directors appointed by the President representing the public policy interests, certainly will enhance that accountability issue.

Mr. NOOJIN. Prior to that, Mr. Chairman, there is an interim board of directors appointed by the President that controls the whole transition process, in taking the Government out of that direct obligation.

Mr. MITCHELL. I won't belabor this, but I hope you would give it a little more concern. Once you get your 15-man Board set up, then you are going to go public for stock purchases, right? You have absolutely no guarantee that that purchase of stock is going to occur so fast that you can end this obligation absolutely. There is no guarantee on that. I am thinking about that little period where you are raising the money to pay off your Federal Government obligation. Why there should not be some Federal representation, at least during that period. I won't pursue it for now, but let's give this some thought. I am sorry, you had a response to that.

Mr. NOOJIN. Well, one-third of the Board is appointed by the President during that period. That is part of the 15-man Board.

Mr. MITCHELL. Right.

Mr. NOOJIN. The five-member public policy portion of the Board. They are permanent.

Mr. MITCHELL. Mr. Hayes.

Mr. HAYES. Would you yield?

Mr. MITCHELL. I would be delighted to yield.

Mr. HAYES. You mean a 15-person Board, don't you?

Mr. NOOJIN. Absolutely.

Mr. MITCHELL. Well, I do want to play with that a little bit because it would certainly seem to me that even with the Presidential appointments it ought to be someone with some kind of Small Business Administration background and someone with some kind of SEC background. I am not talking about Members of Congress being on the Board, although I might enjoy that, but I have expressed my concern.

Are there other questions?

Congressman Torres, do you have additional questions?

Mr. TORRES. No.

Mr. MITCHELL. Mr. Dreier.

Mr. Dreier. Thank you, Mr. Chairman.

I would like to follow up on the first question that was asked by the chairman, to clarify for the record. We are talking about private markets picking up what now exists solely through Small Business Administration. I was wondering if either of you believe that there is enough demand in the private capital markets to absorb areas other than SBIC and MESBIC, specifically thinking of the 7(a) guarantee program, which now exists with the Small Business Administration?

Mr. NOOJIN. Enough demand?

Mr. DREIER. Enough demand in private capital markets to absorb other than just the SBIC and MESBIC areas?

Mr. NOOJIN. Oh, absolutely. I did not come with a command of statistics, Mr. Dreier, but as witnessed by the $5 billion a week in municipal securities that have been sold the last 4 months, and probably $20 billion a week between now and—there is an inexhaustible demand for securities of this nature.

Mr. DREIER. Based on that you might be able to address the problem the chairman has been raising about the transition period.

Mr. NOOJIN. We think it will be almost simultaneous. We have commitments, from the major investment banking houses on Wall Street that are bidding to take this billion dollars in securities from us.

Mr. DREIER. So you feel then that the private capital markets could effectively absorb areas such as the 7(a) guarantee program along with the SBIC and MESBIC, that there is enough of a pool there?

Mr. NOOJIN. Well, there is an existing pool for 7(a) securities. There has never been a problem absorbing not only what the Government is offering on the market but what the private corporations are offering.

Mr. DREIER. What I am speaking about specifically is the move toward further privatization.

Mr. HILL. I think there is an appetite. I think as long as the investing public can be assured that when there is uniformity and liquidity in the securities that they purchase, and return on these securities is commensurate with the risk, the investing public perceived I think there is a demand in the public for—you certainly are aware of the proliferation of industries and creative industries that have introduced into the financial marketplace in the last several years and I think that is a continuation of that process. I think there would be an appetite for additional kinds of securities, as long as they did provide liquidity to the investors and there was a return commensurate with the risk of these securities.

Mr. DREIER. Well, thank you very much, Mr. Chairman, and thank you, and again I hope that my enthusiastic support for this legislation and cosponsorship with you on this bill in no way jeopardizes its passage.

Mr. MITCHELL. In a brief private exchange, I expressed the extent of my concern for the well-being of this bill. My concern being caused in part by some of those who have consponsored it.

Thank you.

Mr. Hayes, any additional questions?

Mr. HAYES. No.

Mr. MITCHELL. Let me follow up, because it pretty much is related to his line of questioning.

You set the trust fund up and it would last 50 years. My problem is that right now the annual appropriation for MESBIC's is approximately $41 million. What annual level of funding do you anticipate if the Corporation for Small Business Investment becomes operational? Would it be less than the $41 million or more than?

Mr. HILL. I think initially it would be close to that level. We are in the process now of continuing to work out the actuarial implications. I certainly don't think there would be any diminution of the funding available as a result of COSBI.

Mr. MITCHELL. If you go your full 50 years with your trust fund, what would be the income that the trust fund will receive over its 50-year period?

Mr. HILL. I am not sure I can——

Mr. MITCHELL. Can you anticipate?

Mr. HILL. I am not sure I can cite numbers over that period. I know we have taken a look at preliminary numbers on existing securities that would go into the trust, $100 million initial appropriations investment in the trust, and based on those preliminary numbers there would be sufficient funds to provide capital for the ongoing process and we would anticipate some transition of MESBIC's to SBIC's as we move forward in the program.

Mr. MITCHELL. I have to put the same thing to you, Mr. Noojin, your present level of funding is what?

Mr. NOOJIN. $250 million.

Mr. MITCHELL. What level do you anticipate annually through COSBI?

Mr. NOOJIN. I anticipate a steady increase on a yearly basis.

Mr. MITCHELL. Do you think in the first year of its operation you could anticipate at least matching your present level of appropriations?

Mr. NOOJIN. I would expect so; yes, sir.

Mr. MITCHELL. OK.

Sorry to keep you but as I said, this is a very complex piece of legislation and I want all the members of the full committee and the subcommittee to have as much information as possible. That is why I want to raise some concerns and try to get some very definitive answers.

Under COSBI each SBIC would have the right to purchase stock in the Corporation. If it does not do so, as I understand it, then under the present arrangements it would be delicensed, is that correct?

Mr. NOOJIN. There would be some winding down. They would not participate in the COSBI Program and since the Small Business Administration aspect of the SBIC Program no longer would be in existence there would be some transition period out of the program.

Mr. MITCHELL. In effect they would be delicensed?

Mr. NOOJIN. Yes.

Mr. MITCHELL. How do you feel about allowing those SBIC's that don't want to purchase COSBI stock to remain as Small Business Administration licensees either with or without funding? As they are preserving another source of small business venture capital, how do you feel about that, either one of you? Does that muddy the waters too much?

Mr. NOOJIN. I think it does. A perfect example is the NASD and broker dealers. I think it is mandatory that we have all active people in this program as participants in the COSBI capital bank. I don't think it is without precedent and our initial surveys of the industry have indicated that the overwhelming majority thus far think that paying for the participation in COSBI is something that they should do. They are very much in favor of it.

Mr. HILL. Another issue is the size. The SBIC and MESBIC industries, of course, are very important to us because they represent our livelihood but in the scheme of things, in the scheme of financial markets, venture capital markets, the Government in general, it is pretty small potatoes and to talk about splitting that further into two or more different groups, having one group with COSBI and the other not, I think the cost far outweighs any benefits gained. I can't envision very many SBIC's and MESBIC's wanting to operate outside COSBI.

Mr. MITCHELL. If other members have questions, I will stop. I have a few more I would like to put to you.

The billion-dollar backup through Treasury, how do you arrive at that billion-dollar figure?

Mr. NOOJIN. The billion dollars, first of all, is not a concrete number, but in working with the investment banking houses, we were trying to establish a number that would give the greatest amount of credibility and thereby the greatest facilitation to the liquidity of these instruments. Actually, the number was suggested by the houses that are going to be selling the securities. They pointed to the existing agencies and the backstops that are in operation there.

Mr. MITCHELL. Well, once COSBI gets operational and continues to grow, it is possible that that backstop figure might be lowered?

Mr. NOOJIN. I think, Mr. Chairman——

Mr. MITCHELL. Or adjusted in some way?

Mr. NOOJIN. As the capital base and the familiarity of the marketplace with COSBI improves, I think it could possibly be lowered. But, by the same token, as those positive features come into play, there is even less possibility that it will ever be called upon. So, I think the necessity for that is quite evident in the existing agencies and the acceptance of their securities.

Mr. MITCHELL. There are a number of institutions in which there is that kind of backstop which has never been called on. However, the mood of the Congress is so budget oriented, I think there might be some concern, about the extent of backstop money through Treasury and other sources, whether that is going to be a permanent kind of fixture. Although it is not costing anyone anything, there might be some concern in the Congress on that basis.

You are going to establish your own operating standards in lieu of Small Business Administration regulations and I must say that I, too, throughout the years have enormous concern about Small Business Administration regulations. I think sometimes they are too tight. On the other hand, some Small Business Administration regulations are pretty good and I wouldn't want to see them totally scrapped. What I would like to suggest is that maybe we send to you some of the Small Business Administration regulations that I think are very prudent and good regulations, and see whether or not your private board of directors would consider utilizing those existing regulations.

I am not talking about the ones that require inordinate boxes of paper clips, that kind of foolishness. I am talking about sound regulations. Would you have any objection to that?

Mr. NOOJIN. None whatsoever.

Mr. MITCHELL. We will pick out the best ones we think make sense, and send them over for your private board to consider.

Mr. NOOJIN. It is currently contemplated that those regulations or something similar will stay in place. Indeed, it has more to do with the mechanism than the concept when we say a more streamlined regulatory process.

Mr. MITCHELL. OK.

Mr. NOOJIN. So we would welcome that.

Mr. MITCHELL. Good.

You talked about the sale to COSBI of the existing portfolio of SBIC debentures now held by the Federal Financing Bank, on terms to permit COSBI to be self-sustaining and financially sound. Will that sale be at fair market value? Will it be a subsidy?

Mr. NOOJIN. We anticipate that the sale will be at less than face value of the securities primarily based upon an evaluation of those securities. All of those securities do not represent debentures issued by sound small business investment companies and therefore, we don't envision all of them are collectable. So we would anticipate that the evaluation process would approximate market, but it would not be face value.

Mr. MITCHELL. Then you do not anticipate any subsidy? You may well if you are going to sell maybe at less than market value?

Mr. NOOJIN. I guess it is definitional, Mr. Chairman.

To the extent debentures deemed uncollectable prior to the purchase are collected, that clearly would be a subsidy, but an unanticipated one. It is my understanding we are not asking for a subsidy to take those debentures off the Government's hands, merely a market evaluation.

Mr. MITCHELL. I just have two more questions. COSBI will be financed primarily through the issuance of the debt securities similar to those of other Federal entities, such as Fannie Mae, which have the authority to issue securities. Before doing that, Fannie Mae has to get prior approval from the Treasury. Would that same situation be taken with reference to COSBI?

Mr. NOOJIN. Before earning—I am sorry.

Mr. MITCHELL. Issuance of debt securities. That is how you are going, primarily, to finance COSBI, right?

Mr. NOOJIN. Right.

Mr. MITCHELL. Staff looked at Fannie Mae and it also has the same authority to do this. Before it can do it, it has got to get approval, prior approval by the Secretary of the Treasury. Do you anticipate anything like that in the Corporation for Small Business Investment operations, some kind of prior approval before you actually finance through debt securities?

Mr. NOOJIN. The bill does not contemplate that provision at the present time; no, sir. Prior consultation.

Mr. MITCHELL. Prior consultation but not prior approval?

Mr. NOOJIN. Right.

Mr. Chairman, the market will make an effective determination of the amount of these securities that can be sold. If the efficiency of the marketplace deems these securities to be higher risk because there are more of them available, then the price will exceed the demand.

Mr. MITCHELL. The last question is with your testimony, where you talk about other capital sources. I am trying to get some feel for how much money you anticipate raising from the sale of debentures or debt securities and how much do you anticipate in terms of stock?

Mr. NOOJIN. Well, we anticipate an initial capitalization of $20 million for COSBI paid in capital. We said $20 million increasing annually by the increased retained earnings of its members, by the addition of new members, and possibly by capital calls on its members if necessary. We feel that once the credibility of the organization is established, that capital notes, for example, and/or different equity instruments, such as preferred stock, that do not equate to voting rights or dilution of SBIC and MESBIC ownership, could be issued to enhance the capital position of the company. That is not

contemplated at the present time. It is merely a vehicle that would possibly be available.

As to the amount of debentures sold by COSBI that would have a direct relationship to two principal things: first, the demand for the debentures by its stockholder members; and second, market acceptance of those debentures.

Mr. MITCHELL. I understand that. But surely you must have some kind of projection on that, on how much maybe the first year you might get through debentures?

Mr. NOOJIN. Well, we think the first year we will have approximately $250 million in debenture sales, in addition to the initial portfolio acquisition. That is the current level, $250 million. We think the second year that will increase by an additional $300 million. We think the third year will increase by $350 million. So we can see a continuation and a gradual increase in the program of say a 10- to 15-percent increase in demand for leverage each year.

Mr. MITCHELL. OK.

Any other questions?

Because this is a kind of rough piece to deal with in terms of being very complex, I am going to ask the staff if they have any questions they want to raise. If there are other questions, I would like to submit them to you and get replies as speedily as possible.

Mr. NOOJIN. I would like to add, if I may, Mr. Chairman, that the detailed financial model of the company has not been completed at this point, but merely approximated using extremely hypothetical presumptions. The reason being we cannot accurately do that model until we know the shape and form of the final bill. We can make available to staff our deliberations at this point, and test any number of possibilities, but that is a reality at the present time.

Mr. MITCHELL. You co-opted me. I was going to say just the opposite. Before we finalize the bill, I think we ought to have a few more specifics about this.

Mr. NOOJIN. That will be no problem.

Mr. MITCHELL. We won't run the bill too far ahead of your finalization of specifics.

Gentlemen, thank you very much. It is exciting. It is a very daring and exciting new venture. As you know, I am committed to it.

Mr. NOOJIN. Thank you.

Mr. HILL. Thank you very much.

Mr. MITCHELL. The hearing is now adjourned.

[Whereupon at 11:50 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

APPENDIX A.—THE BILL H.R. 3484

99TH CONGRESS
1ST SESSION

H. R. 3484

To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment and to transfer certain functions of the Small Business Administration to the Corporation.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 2, 1985

Mr. MITCHELL (for himself, Mr. MCDADE, Mr. ADDABBO, Mr. GONZALEZ, Mr. BEDELL, Mr. NOWAK, Mr. LUKEN, Mr. SKELTON, Mr. STENHOLM, Mr. MAVROULES, Mr. HATCHER, Mr. WYDEN, Mr. ECKART of Ohio, Mr. SAVAGE, Mr. ROEMER, Mr. SISISKY, Mr. TORRES, Mr. COOPER, Mr. OLIN, Mr. RAY, Mr. HAYES, Mrs. LONG, Mr. CHAPMAN, Mr. ROBINSON, Mr. CONTE, Mr. BROOMFIELD, Mr. IRELAND, Mr. HILER, Mr. WEBER, Mr. DREIER of California, Mr. KOLBE, Mr. COBEY, Mr. COBLE, Mr. DIO-GUARDI, Mrs. MEYERS of Kansas, Mr. GALLO, and Mr. GROTBERG) introduced the following bill; which was referred to the Committee on Small Business

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A BILL

To amend the Small Business Investment Act of 1958 to create the Corporation for Small Business Investment and to transfer certain functions of the Small Business Administration to the Corporation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Corporation for Small Business Investment Charter Act".

PURPOSES

SEC. 2. Section 661 of title 15, United States Code, is amended to read as follows:

"The Congress hereby declares that the purposes of this Act are—

"(1) to establish a Government-sponsored private corporation which will be financed by private capital and which will serve as a secondary market and warehousing facility for loans to and investments in small business investment companies, including loans guaranteed by the Small Business Administration, and will provide liquidity for small business loans and investments;

"(2) to stimulate and supplement the orderly and necessary flow of private equity capital and long-term loan funds to and improve the distribution of investment capital available for small business concerns as defined in the Small Business Act;

"(3) to amend the Small Business Investment Act of 1958 to provide for an orderly transfer of certain functions of and securities guaranteed by the Small Business Administration to the Corporation for Small Business Investment as constituted under this Act.".

TECHNICAL AMENDMENTS

SEC. 3. As of the effective date of this section of the Act, sections 681, 682, 685, 686, 687, and 687(c) through 687j, inclusive of title 15, United States Code, are repealed. All specific references to small business investment companies operating under the Small Business Investment Act of 1958 in any law of the United States, or regulations promulgated thereunder by an agency of the United States Government, or any law of any State in effect on the effective date of this Act, shall be deemed to refer to and include small business investment companies operating under the provisions of this Act.

DEFINITIONS

SEC. 4. (a) Section 662 of title 15, United States Code, is amended—

(1) by striking out "paragraph (3)" and inserting in lieu thereof:

"(3) the term 'small business investment company' means an organization qualified to conduct business with the Corporation pursuant to section 7 of this Act and shall include small business investment companies licensed and approved by the Administration to operate under the provisions of section 681 of title 15, United States Code, prior to the effective date of this Act;"

(2) by inserting after paragraph (8) the following new paragraphs:

"(9) the term 'Corporation' means Corporation for Small Business Investment, as constituted under this Act. The Corporation shall be classified as and considered to be a corporate instrumentality of the United States;

"(10) the term 'Board of Directors' means the Board of Directors of the Corporation;

"(11) the term 'law' includes any law of the United States or any State (including any rule of law or of equity);

"(12) the term 'organization' means any corporation, partnership, association, business trust, or other business entity;

"(13) the term 'security' has the meaning ascribed to it by section (2)(i) of the Securities Act of 1933;

"(14) the term 'small business investment security' shall include—

"(a) debentures, bonds, promissory notes, obligations or securities issued by small business investment companies, and

"(b) such other small business investment company securities as determined by the Corporation;".

EQUITY CAPITAL, LONG-TERM LOANS AND ADVISORY SERVICES FOR SMALL-BUSINESS CONCERNS

SEC. 5. (a) Section 684 of title 15, United States Code, is amended—

(1) by striking out "regulations of the Administration" in paragraph (a) and inserting in lieu thereof "rules of the Corporation".

(2) by striking out "paragraphs (b) and (d) and inserting in lieu thereof the following new paragraphs:

"(b) Equity investments and loans made under this section may be made directly or in cooperation with other investors or lenders on a participation or guaranteed basis.

"(c) Each small business investment company may provide consulting and advisory services on a fee basis and have on its staff persons competent to provide such services.".

ESTABLISHMENT OF THE CORPORATION

SEC. 6. (a) There is hereby created a body corporate to be known as the Corporation for Small Business Investment (hereinafter referred to as the "Corporation"). The Corporation shall have succession until dissolved. It shall maintain its principal office in the District of Columbia and shall be deemed, for purposes of venue and jurisdiction in civil actions, to be a resident and citizen thereof. Offices may be established by the Corporation in such other place or places as it may deem necessary or appropriate for the conduct of its business.

(b) The Corporation, including its franchise, capital, reserves, surplus, mortgages, or other security holdings, and income shall be exempt from all taxation now or hereafter imposed by any State, or by any county, municipality, or local taxing authority, except that any real property of the Corporation shall be subject to State, county, municipal, or local taxation to the same extent according to its value as other real property is taxed.

(c)(1) The Corporation shall have a permanent Board of Directors which shall consist of fifteen persons.

(2) An interim Board of Directors shall be appointed by the President, one of whom he shall designate as interim Chairman. The interim Board shall consist of five members, two of whom shall be representative of small business, two of whom shall be representative of small business investment companies, and one of whom shall be the Administrator. The interim Board shall arrange for an initial offering of common stock and take whatever other actions are necessary to proceed with the operations of the Corporation.

(3) When $20,000,000 of common stock of the Corporation has been purchased by small business investment companies, banks, financial institutions or other organizations interested in small business investments, as determined by the Corporation, the holders of common stock shall elect ten

members as the Board of Directors. The President shall appoint the remaining five directors.

(4) At the time the events described in paragraph (3) have occurred, the interim Board shall turn over the affairs of the Corporation to the permanent Board so chosen or appointed.

(5) The directors appointed by the President shall serve at the pleasure of the President and until their successors have been appointed and have qualified. The Board shall at all times have as a member appointed by the President at least one person from a small business investment company, as defined in section 8 of this Act. The remaining directors shall each be elected for a term ending on the date of the next annual meeting of the common stockholders of the Corporation, and shall serve until their successors have been elected and have qualified. Any appointive seat on the Board which becomes vacant shall be filled by appointment of the President. Any elective seat on the Board which becomes vacant after the annual election of the directors shall be filled by the Board, but only for the unexpired portion of the term.

(6) The Board shall determine the general policies which shall govern the operations of the Corporation. The Board shall select, appoint, and compensate qualified persons to fill the offices as may be provided for in the bylaws, with such executive functions, powers, and duties as may be pre-

scribed by the bylaws or by the Board of Directors, and such persons shall be the executive officers of the Corporation and shall discharge all such executive functions, powers, and duties.

(d) The Corporation shall have power—

(1) to sue and be sued, complain and defend, in its corporate name and through its own counsel;

(2) to adopt, alter, and use the corporate seal, which shall be judicially noticed;

(3) to adopt, amend, and repeal by its Board of Directors, bylaws, rules, and regulations as may be necessary for the conduct of its business;

(4) to conduct its business, carry on its operations, and have officers and exercise the power granted by this section in any State without regard to any qualification, licensing or similar statute in any State;

(5) to lease, purchase, or otherwise acquire, own, hold, improve, use, or otherwise deal in and with any property, real, personal, or mixed, or any interest therein, wherever situated;

(6) to accept gifts or donations of services, or of property, real, personal, or mixed, tangible or intangible, in aid of any of the purposes of the Corporation;

(7) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of its property and assets;

(8) to appoint such attorneys, officers, employees, and agents as may be required, to determine their qualifications, to define their duties, to fix their compensation, require bonds for them and fix the penalty thereof; and

(9) to enter into contracts, to execute instruments, to incur liabilities, and to do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business.

(e) The Administration shall furnish to the Corporation all books and records of the Administration necessary to carry out the provisions of this Act within thirty days after written request by the Corporation unless the Administrator certifies to the Corporation that such books and records are not available within such time.

LOAN AND INVESTMENT OPERATIONS

SEC. 7. (a) The Corporation is authorized, subject to the provisions of this section, pursuant to commitments or otherwise, to make advances on the security of, purchase, or repurchase, service, sell or resell, offer participations or pooled interests or otherwise deal in, at prices and on terms and conditions determined by the Corporation, small business investment securities.

(b) Notwithstanding the provisions of any State law to the contrary, including the Uniform Commercial Code as in effect in any State, a security or ownership interest in small business investment securities created by the Corporation or by any eligible small business investment company may be perfected either through the taking of possession of such securities or by the filing of notice of such interest in such securities in the manner provided by said State law for perfection of security or owership interests in accounts.

(c) The Corporation is authorized to guarantee securities based on or secured by pools or trusts of the small business investment securities eligible for purchase by the Corporation under this section and to act either as issuer of such securities or as guarantor of such securities issued by an eligible small business investment company. Such securities shall bear interest at a rate equal to the rate on the underlying small business investment securities less an allowance for servicing and other expenses as determined by the Corporation.

(d) Securities issued pursuant to subsection (c) of this section may be in the form of debt obligations secured by pools of loans, or trust certificates of beneficial ownership in such pools of loans, or both. Small business investment securities set aside pursuant to the offering of participations or pooled interests shall at all times provide for payments ade-

quate (in reasonable judgment of the Corporation) to ensure the timely principal and interest payments on such securities.

(e)(1) The Corporation shall establish appropriate criteria for the qualification of small business investment companies to conduct business with the Corporation. Such criteria may include, among other things, a need and availability for the financing of small business concerns in the geographic area in which the small business investment company operates, the general business reputation and character of the owners and management of the small business investment company and the probability of successful operations of such small business investment company, including adequate profitability and financial soundness.

(2) Each small business investment company authorized to operate under this section shall have a combined private paid-in capital and paid-in surplus in an amount adequate to assure a reasonable prospect that the company will be operated soundly and profitably, and managed actively and prudently.

(3) Notwithstanding the provisions of section 371c of title 12, United States Code, ownership interests in small business investment companies shall be eligible for purchase by national banks, and shall be eligible for purchase by other member banks of the Federal Reserve System and nonmember insured banks to the extent permitted under applica-

ble State law; except that in no event may any such bank acquire ownership interests in any small business investment company if, upon the making of that acquisition the aggregate amount of ownership interests in small business investment companies then held by the bank would exceed 5 per centum of its capital and surplus.

(4) Each small business investment company shall have authority to purchase stock issued by the Corporation and to borrow money and to issue its debenture bonds, promissory notes, or other obligations under such general conditions and subject to such rules as the Corporation may prescribe.

(5) Small business investment companies licensed and approved by the Administration to operate under the provisions of section 681 of title 15, United States Code, prior to the effective date of this Act and which make capital contributions and acquire common stock of the Corporation pursuant to section 10 of this Act shall be deemed to be small business investment companies operating under the authority of section 7 of this Act. Such small business investment companies which elect not to qualify as small business investment companies under section 7 of this Act and do not make capital contributions and acquire common stock of the Corporation shall cease being "small business investment companies", as defined in this Act, on the effective date of this section of the Act. The Administration is authorized to pre-

scribe regulations governing the continued operations of such former small business investment companies, in accordance with the purposes of this Act. The administration of such regulations shall be carried out by the Corporation through an agreement with the Administration.

SPECIAL SMALL BUSINESS INVESTMENT COMPANIES

SEC. 8. Section 683 of title 15, United States Code, is amended as follows:

(1) by striking out "subsections (a) and (b)" and inserting in lieu thereof:

"(a) The Corporation shall adopt reasonable criteria regarding the qualification of a special type of small business investment company, the investment policy of which is that its investments will be made solely in small business concerns which will contribute to a well-balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages."; and

(2) by striking out subsection (c) and inserting in lieu thereof:

"(b) Subject to the following conditions, the Corporation is authorized, to purchase preferred securities, and to purchase, or to guarantee the timely payment of all principal and interest payments as scheduled, on debentures issued by small business investment companies operating under this section. Such purchases or guarantees may be made by the

Corporation on such terms and conditions as it deems appropriate.

"The Corporation may purchase—

"(1) shares of nonvoting stock (or other securities having similar characteristics), provided—

"(i) dividends are preferred and cumulative to the extent of 3 per centum of par value per annum;

"(ii) on liquidation or redemption the Corporation is entitled to the preferred payment of the par value of such securities; and prior to any distribution (other than to the Corporation) the Corporation shall be paid any amounts as may be due pursuant to subparagraph (i) of this paragraph;

"(iii) the purchase price shall be at a price less than par value and, in any one sale, $50,000 or more; and

"(iv) the amount of such securities purchased and outstanding at any one time shall not exceed 200 per centum of the combined private paid in capital and paid in surplus of such company. The amount of such securities purchased by the Corporation in excess of 100 per centum of such capital and surplus from any company may not exceed an amount equal to the amount of its

funds invested in or legally committed to be invested in venture capital as determined by the Corporation. For the purposes of the subsection, the term 'venture capital' means stock of any class (including preferred stock) or limited partnership interests, or shares in a syndicate, business trust, joint stock company or association, mutual corporation, cooperative or other joint ventures for profit or debt instruments which are subordinated by their terms to other borrowings of the issuer.

"The Corporation may purchase or guarantee—

"(2) debentures which shall be subordinate to any other debentures, bonds, promissory notes or other debts and obligations of such companies unless the Corporation in its exercise of reasonable investment prudence and in considering the financial soundness of such company determines otherwise, provided—

"(i) the effective rate of interest during the first five years of the term of any debenture purchased by the Corporation under authority of this section, shall be 3 percentage points below the rate determined by the Corporation to be the rate of return on comparable small business investment securities purchased by the Corporation; plus such

additional charge, if any, toward covering other costs of the program as the Corporation may determine to be consistent with its purposes;

"(ii) the amount of debentures purchased or guaranteed and outstanding at any one time pursuant to this paragraph (2) from a company having combined private paid-in capital and paid-in surplus of $500,000 or more, shall not exceed 400 per centum of its combined private paid-in capital and paid-in surplus less the amount of such preferred securities;

"(3) debentures purchased and outstanding pursuant to subsection (b) of this section may be retired simultaneously with the issuance of preferred securities to meet the requirements of subparagraph (2)(ii) of this subsection (b);";

(3) by adding the following new subsections (c), (d), and (e) as follows:

"(c) The Corporation is authorized to extend the benefits of this section to any small business investment company operating under authority of this section, and which is owned, in whole or in part, by one or more small business investment companies, in accordance with rules promulgated by the Corporation.

"(d) The Corporation and the Administration are authorized and directed to enter into an agreement whereby the Corporation will acquire all of the right, title, and interest to (1) preferred securities and debentures issued by small business investment companies operating under authority of section 681(d) of title 15, United States Code, and held by the Administration, and (2) funds held by the Administration representing the reserve for losses against such preferred securities and debentures. Such preferred securities, debentures, and loss reserve funds shall be transferred from the Administration to the Corporation as of the effective date of this section of the Act. The Corporation shall hold such securities, debentures, loss reserve funds, and other available funds in trust and administer such trust through five trustees nominated by the special small business investment companies and appointed by the Board of Directors of the Corporation. At least three of the trustees shall be persons from small business investment companies, as defined in section 8 of this Act. The Corporation shall administer and account for such preferred securities, debentures and funds held in trust as follows:

"(1) For a period of fifty years from the effective date of this section of the Act, all of the funds held in trust and income thereon, dividends on any preferred securities held in trust, and interest on the debentures

held in trust, together with the proceeds from any retired preferred securities held in trust, and proceeds from the maturing debentures held in trust shall be applied by the Corporation—

"(i) to cover any losses realized on preferred securities or debentures held in trust, preferred securities purchased by the Corporation in accordance with the provisions of subsection (b)(1) of this section or debentures purchased or guaranteed by the Corporation in accordance with the provisions of subsection (b)(2) of this section;

"(ii) to reduce the interest rate on debentures purchased or guaranteed by the Corporation in accordance with the provisions of subsection (b)(2) of this section;

"(iii) to purchase preferred securities in accordance with the provisions of subsection (b)(1) of this section;

"(iv) to cover the operating costs of the Corporation in administering the trust; and

"(v) for purposes of this subsection (d)(1), all dividends on the preferred securities, interest on the debentures, gains from sales of any of said securities and all other income of the trust shall be exempted from all taxation now or hereafter im-

posed by the Congress or by any State or by any county, municipality, or local taxing authority.

"(2) Fifty years after the effective date of this section of the Act, all preferred securities purchased by the Corporation from small business investment companies operating under the authority of this section shall be redeemed and shall be transferred by the Corporation to the Treasury for covering into miscellaneous receipts. Small business investment companies operating under the authority of this section thereafter shall operate under the authority of section 7 of this Act.

"(3) For purposes of this subsection (d), the Corporation will establish separate accounting for all such preferred securities, debentures, loss reserves and other funds acquired and the application of funds for the purposes specified in this subsection. An annual accounting of the Corporation's operations under this subsection shall be made to the Secretary of the Treasury pursuant to the provisions of Section 13 of the Act.

"(e) There are authorized to be appropriated such sums as are necessary for the Corporation to carry out the trust functions and operations of the Corporation for special small business investment companies under subsection (b)(1) of this section for the term of the trust.".

OPERATIONS OF SMALL BUSINESS INVESTMENT COMPANIES

SEC. 9. (a) The Corporation is authorized to enter into agreements with small business investment companies governing the operations of such companies, and to carry out the provisions of this Act, in accordance with the purposes of this Act.

(b) For the purpose of controlling conflicts of interest which may be detrimental to small business concerns, to small business investment companies, to the shareholders or partners of either, to the Corporation, or to the purposes of this Act, the Corporation shall adopt rules to govern transactions with any officer, director, shareholder, or partner of any small business investment company, or with any person or concern, in which any interest, direct or indirect, financial or otherwise, is held by any officer, director, shareholder, or partner of (1) any small business investment company, or (2) any person or concern with an interest, direct or indirect, financial or otherwise, in any small business investment company. Such rules shall include appropriate requirements for public disclosure (including disclosure in the locality most directly affected by the transaction) necessary to the purposes of this section.

(c) The Corporation shall establish criteria to assure that a small business concern eligible for investment by a

small business investment company is independently owned and operated and is not dominant in its field of operation. In making a detailed definition of a small business concern, the Corporation shall use those criteria set forth in section 632 of title 15, United States Code.

(d) Without the approval of the Corporation, the aggregate amount of obligations and securities acquired and for which commitments may be issued by any small business investment company under the provisions of this Act for any single enterprise shall not exceed 20 per centum of the combined private paid-in capital and paid-in surplus of such company. In the case of small business investment companies operating under section 8 of this Act, the limitation shall be 30 per centum.

COMMON AND PREFERRED STOCK

SEC. 10. (a) The Corporation shall have common stock, having such par value as may be fixed by its Board of Directors from time to time, which shall be vested with all voting rights, each share being entitled to one vote with rights of cumulative voting at all elections of directors. The Corporation is authorized to issue nonvoting common stock having such par value as may be fixed by its Board of Directors from time to time. The free transferability of the common stock at all times to any person, firm, corporation, or other entity shall not be restricted except that, as to the

Corporation, it shall be transferable only on the books of the Corporation.

(b) The Corporation may accumulate funds for its capital surplus account from private sources by requiring each small business investment company to make payments of nonrefundable capital contributions, as determined from time to time by the Corporation, taking into consideration conditions in the capital and money markets and the general economy. Within any two-year period, such required capital contributions shall not exceed five percent of the combined private paid-in capital of the small business investment companies operating under the authority of this Act unless a majority of the Corporation's shareholders shall have given its prior approval.

(c) The Corporation shall issue from time to time, to each small business investment company, its common stock evidencing any capital contributions made by such seller or borrower pursuant to subsection (b) of this section. In addition to the shares of common stock issued under the foregoing sentence, the Corporation may issue additional shares in return for appropriate payments into capital or capital and surplus. Such dividends as may be declared by the Board of Directors in its discretion shall be paid by the Corporation to the holders of its common stock.

(d) Notwithstanding any other provision of law, any depository institution, as defined in section 19(b)(1)(A) of the Federal Reserve Act, as amended (title 12, United States Code, section 461(b)(1)(A) shall be authorized to make payments to the Corporation of the capital contributions referred to in subsections (b), (c), and (e) of this section, to receive stock of the Corporation evidencing such capital contributions, to purchase additional shares of such stock, and to hold or dispose of such stock, subject to the provisions of this Act.

(e)(1) The Corporation is authorized to issue preferred stock, having such par value as may be fixed by its Board of Directors from time to time. Any preferred shares issued shall be freely transferable, except that, as to the Corporation, it shall be transferred only on the books of the Corporation.

(2) The holders of the preferred shares shall be entitled to such rate of cumulative dividends and such shares shall be subject to such redemption or other conversion provisions as may be provided for at the time of issuance. No dividends shall be payable on any share of common stock at any time when any dividend is due on any share of preferred stock and has not been paid. The Corporation may prescribe that any class of preferred stock of the Corporation may be converted into voting or nonvoting common stock of the Corporation.

(3) In the event of any liquidation, dissolution, or winding up of the Corporation's business, the holders of the preferred shares shall be paid in full at par value thereof, plus all accrued dividends, before the holders of the common shares receive any payment.

OBLIGATIONS AND SECURITIES

SEC. 11. (a) The Corporation is authorized to issue and have outstanding obligations having such maturities and bearing such rate or rates of interest as may be determined by the Corporation. Such obligations shall be issued at such times, bear interest at such rates, and contain such terms and conditions as the Corporation shall determine, after consultation with the Secretary of the Treasury. Such obligations may be redeemable at the option of the Corporation before maturity in such manner as may be stipulated therein. The Corporation shall insert appropriate language in all of its obligations issued under this subsection and under section 7 clearly indicating that such obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than the Corporation. The Corporation is authorized to purchase in the open market any of its obligations outstanding under this subsection at any time and at any price. Any obligation or security of the Corporation may be issued and sold in definitive form, in book entry form or in

such other form, with or without delivery of physical evidence of ownership, as shall be prescribed by the Corporation.

(b) For the purposes of this section, the Corporation is authorized to issue obligations which are subordinated to any or all other obligations of the Corporation, including subsequent obligations. The obligations issued under this subsection shall have such maturities and bear such rate or rates of interest as may be determined by the Corporation and may be made redeemable at the option of the Corporation before maturity in such manner as may be stipulated in such obligations. Any of such obligations may be made convertible into shares of common stock in such manner, at such price or prices, and at such time or times as may be stipulated therein.

(c) The Secretary of the Treasury is authorized in his discretion to purchase any obligations issued by the Corporation pursuant to subsection (a) as not or hereafter in force, and for such purpose the Secretary of the Treasury is authorized to use as a public debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force, and the purposes for which securities may be issued under the Second Liberty Bond Act, as now or hereafter in force are extended to include such purchases. The Secretary of the Treasury shall

not at any time purchase any obligations under this subsection if such purchase would increase the aggregate principal amount of his then outstanding holdings of such obligations under this subsection to an amount greater than $1,000,000,000. Each purchase of obligations by the Secretary of the Treasury under this subsection shall be upon such terms and conditions as to yield a return at a rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States of comparable maturities as of the last day of the month preceding the making of such purchase. The Secretary of the Treasury may, at any time, sell, upon such terms and conditions and at such price or prices as he shall determine, any of the obligations acquired by him under this subsection. All redemptions, purchases, and sales by the Secretary of the Treasury of such obligations under this subsection shall be treated as public debt transactions of the United States.

LEGAL INVESTMENTS AND EXEMPT SECURITIES

SEC. 12. All obligations issued by the Corporation pursuant to sections 7 and 11, all preferred stock issued by the Corporation pursuant to section 10 and all obligations guaranteed by the Corporation pursuant to section 7 shall be lawful investments, and may be accepted as security for all fiduciary, trust, and public funds, the investment or deposit of which shall be under authority or control of the United States

or of any officer or officers thereof. All stock and obligations issued by the Corporation shall be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission, to the same extent as securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States. The Corporation shall, for the purposes of section 355(2) of title 12, United States Code, be deemed to be an agency of the United States. The obligations of the Corporation shall be deemed to be obligations of the United States for purposes of section 3124 of title 31, United States Code. For the purpose of section 101(30) of title 11, United States Code, the Corporation shall not be a governmental unit, but shall instead be a corporation.

AUDITS AND REPORTS

SEC. 13. (a) The accounts of the Corporation shall be audited annually. Such audits shall be conducted in accordance with generally accepted auditing standards by independent certified public accountants who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States. A report of each such audit shall be furnished to the Secretary of the Treasury. The audit shall be conducted at the place or places where the accounts are normally kept. The representatives of the Secretary shall have access to all books, accounts, financial records, reports, files, and all other papers, things, or property belonging to or in

use by the Corporation and necessary to facilitate the audit, and they shall be afforded full facilities for verifying transactions with the balances or securities held by depositaries, fiscal agents, and custodians.

(b) A report of each such audit for a fiscal year shall be made by the Secretary of the Treasury to the President and to the Small Business Committees of the Congress not later than six months following the close of such fiscal year. The report shall set forth the scope of the audit and shall include a statement (showing intercorporate relations) of assets and liabilities, capital and surplus or deficit; a statement of surplus or deficit analysis; a statement of income and expense; a statement of sources and application of funds; and such comments and information as may be deemed necessary to keep the President and the Congress informed of the operations and financial condition of the Corporation, together with such recommendations with respect thereto as the Secretary may deem advisable, including a report of any impairment of capital or lack of sufficient capital noted in the audit. A copy of each report shall be furnished to the Administrator and to the Corporation. In addition to such annual audits, the Corporation shall be subject to audit by the General Accounting Office, at the request of either of the Small Business Committees of the Congress, as long as the Corporation holds small business investment company securities guaranteed by the

Administration and acquired by the Corporation pursuant to section 15 of the Act.

(c) The Corporation shall, as soon as practicable after the end of each fiscal year, transmit to the President, the Small Business Committees of the Congress and the Administrator a report of its operations and activities during each year.

EXEMPTION FROM STATE USURY LAWS

SEC. 14. (a) The purpose of this section is to facilitate the orderly and necessary flow of long-term loans and equity funds from small business investment companies to small business concerns.

(b) The provisions of the Constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges or other charges which may be charged, taken, received, or reserved by lenders shall not apply to any business loan made by a small business investment company pursuant to the provisions of this Act. This section shall apply to business loans made by a small business investment company in any State on or after the effective date of this Act, unless such State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of this section to apply to business loans made in such State. In any case in which a State takes an action described in this

paragraph, such State law or constitutional or other provision shall not apply after the date such action was taken with respect to any business loan made by a small business investment company pursuant to a commitment to make such loan which was entered into on or after the effective date of this Act and prior to the date on which such action was taken.

TRANSFER OF SMALL BUSINESS ADMINISTRATION GUARANTEED SECURITIES TO THE CORPORATION

SEC. 15. (a) To carry out the purposes set forth in section 2 of the Act, the Corporation, the Administrator, the Federal Financing Bank (the "Bank") and the Secretary of the Treasury are authorized and directed to enter into an agreement whereby the Corporation will acquire the right, title, and interest to all small business investment company securities guaranteed by the Administration and held by the Bank. In exchange for such securities, the Corporation will assume all indebtedness of the Bank under the obligations issued by the Bank to the Secretary of the Treasury to fund the Bank's investment in such small business investment company securities. Upon the consummation of the transactions contemplated by this section, the Bank shall be discharged from all liability on the indebtedness assumed by the Corporation. The terms and conditions of the agreement between the Corporation, the Administrator, the Secretary of the Treasury, and the Bank should assure that the Corporation will, as rapidly as possible, substitute private financing

for the obligations issued in accordance with this subsection on a basis that will permit the Corporation to be self-sustaining and financially sound. For purposes of this section, the Corporation will establish separate accounting for all of such securities acquired and obligations issued and will maintain such separate accountability for the management and orderly liquidation of such assets and liabilities as provided in this section. To provide to the maximum extent and as rapidly as possible for the substitution of private financing for the financing provided by the Secretary of the Treasury pursuant to this section, the Corporation may use its authority under section 11 to issue and sell in the private capital markets securities based on or secured by the small business investment company securities acquired by it under this section.

TERRITORIAL APPLICABILITY

SEC. 16. Notwithstanding any other law, this Act shall be applicable to the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the territories, possessions, and dependencies of the United States.

EFFECTIVE DATE

SEC. 17. This Act will be effective upon enactment thereof, except that sections 3, 5, and 8 and subsection 7(e)(5) shall be effective from and after a date, no more than one year following the date of enactment of this Act, as established by the Administrator, upon notification to the Administrator by the Board of Directors of the Corporation that

the Corporation has issued common stock, as provided in section 6 of this Act, and the Corporation has taken all actions necessary to commence loan and investment operations, as provided in section 7 of this Act. Notice of the establishment of such effective date shall be published in the Federal Register at least thirty days prior thereto.

CONSTRUCTION AND SEPARABILITY

SEC. 18. Except as otherwise provided in this Act, or as otherwise provided by the Corporation or by laws hereafter enacted by the Congress expressly in limitation of provisions of this Act, the powers and functions of the Corporation and of the Board of Directors shall be exercisable, and the provisions of this Act shall be applicable and effective, without regard to any other law. Notwithstanding any other evidences of the intention of Congress, it is hereby declared to be the controlling intent of Congress that if any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of this Act, or the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby.

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APPENDIX B.—RESPONSES TO ADDITIONAL QUESTIONS ON COSBI

1. Question -- The Hypothetical COSBI Balance Sheet and Income Statement indicate an interest rate differential in the transaction involving the purchase of SBA-Guaranteed debentures held by FFB. Is this an implicit subsidy?

Answer -- As we have told the Committee staff, we recognize the need to refine and make more specific the nature of the transaction under which COSBI acquires the SBIC debentures currently held by FFB. The relevant provision in the current version of the legislation, which calls for COSBI's purchase of these assets through a negotiated transaction, is unsatisfactory for several reasons, including the probable inability of CBO to score actual budget savings realized by the transaction.

As Mr. Noojin indicated in his testimony (at pp. 80-81 of the transcript), it is intended that COSBI acquire the FFB portfolio on a market value basis. In addition, he also pointed out (at p. 84) that the development of a precise financial model for COSBI would be dependent upon the specific terms of those legislative provisions which circumscribed COSBI's financial structure. Accordingly, it would be misleading to make any conclusive assumptions based on the Hypothetical COSBI Balance Sheet and Income Statement. Those financial projections were intended as examples for discussion only, and should not be used as a basis for a substantive analysis of the COSBI proposal.

2. Question -- At what rate will the $1.0 billion Treasury Note of COSBI be amortized?

Answer -- As indicated above, the terms of this transaction must be made more definitive. However, assuming the transaction is properly structured, it is our expectation that COSBI will be able to pay Treasury in full within a minimum of three years, and very probably within one year.

3 (a). Question -- SBA's statistics do not indicate that the SBIC program has been "stifled" by SBA's administration and regulation of the program during the last five years. Please comment.

Answer -- While this is a subjective and argumentative issue, we believe it is accurate to say that the SBIC industry's growth and increased activity levels during the past five years have been the result of favorable economic conditions external to SBA, including those mentioned in Mr. Noojin's testimony (at p. 8 of the transcript) which gave the industry an enormous momentum as it entered the 1980s. Conversely, when you consider that these achievements have been made despite an adverse governmental climate, think what would have been accomplished had there been a more responsive environment.

3 (b). Question -- The COSBI financial model estimates losses of 1/2 of 1 percent whereas SBA statistics show it might be 5-7 percent. Please comment.

Answer -- The loss estimates in the COSBI hypothetical financials were based on the most recent official SBA statistics made available to us showing actual losses in the SBIC program. We are not aware of SBA figures that reflect a loss rate of 5-7 percent, but would certainly modify our financial model if SBA statistics indicate that is necessary.

4. Question -- SBA statistics show a substantial increase in the number of SBICs moving into its Office of Portfolio Management. Could these have resulted from lax licensing and lax regulation and possibly too may compromises in the 70's?

Answer -- While we have not seen the statistics referred to in this question, we believe it is important not to attempt to draw broad general conclusions from any set of subjectively determined aggregate numbers. This is particularly true with regard to a subject such as the number of companies transferred to Portfolio Management. Because there are a multiplicity of diverse scenarios under which SBICs might be transferred to Portfolio Management, an accurate reflection of what these numbers represent would require an examination of each case individually to determine the exact cause for each action.

5. Question -- Explain the testimony's reflection of a different impact on SBICs as compared to MESBICs resulting from SBA's administration and regulation of the program.

Answer -- See the answer to question #3(a) above.

6. Question -- Provide further detail to justify the statement that there is a problem between SBA and equity-oriented SBICs.

Answer -- During 1982, without notice or discussion with the industry, SBA selectively applied a set of new credit/leverage allocation policies to several SBICs which had equity-oriented portfolios. Those companies, a number of which had outstanding, long-term performance records, were required to execute unusual side-agreements which restricted or added contingencies to their operations. While this "problem" was eventually alleviated after extensive discussions between SBA and the industry, it was noted in the testimony as one of several examples of the type of inconsistent SBA actions which create a continuing atmosphere of uncertainty for the SBIC industry.

7. Question -- Would NASBIC support a broading of the COSBI concept to include the SBA's 503 Development Company program, and SBA's current secondary market program for 7(a) loans and/or all 7(a) loans?

Answer -- No!

8. Question -- It appears that the COSBI proposal transitions bank-owned SBICs out of the SBIC program. How can this be justified?

Answer -- The assumption for this question is fundamentally incorrect. Bank-owned SBICs would not be transitioned out of the program. To the contrary, the Glass-Steagall exemption which authorizes banks to own and operate SBICs is specifically retained in the COSBI legislation. We fully expect present bank-owned SBICs will remain in the program under COSBI and we predict that more banks and other financial institutions will form SBICs under COSBI.

9. Question -- You have indicated that not all SBICs and MESBICs are represented by NASBIC and AAMESBIC, and clearly not all SBICs and MESBICs would benefit from COSBI. What percentage of the industry does NASBIC and AAMESBIC represent?

Answer -- First, we strongly disagree with the assumption that "clearly not all SBICs and MESBICs would benefit from COSBI." In our opinion, every SBIC and MESBIC will realize significant benefits from COSBI.

We would also point out that COSBI is designed to serve the total SBIC and MESBIC industries, without regared to membership in either NASBIC or AAMESBIC. Accordingly, both organizations have made a concerted effort to provide information on COSBI to all operating SBICs and MESBICs and to seek their support.

As to the specifics of NASBIC and AAMESBIC representation, the figures are as follows as of 12/31/85:

	Number	Assets	
SBICs	372	$ 2.177 billion	
NASBIC	293 (79%)	$ 1.977 billion	(91%)
MESBICs	146	$ 407 million	
AAMESBIC & NASBIC	122 (84%)	$ 373 million	(92%)

10. Question -- Clarify the apparent conflict in information relating to the comparisons between SBICs and private venture capital firms in geographic and high tech investment concentrations.

Answer -- We do not believe there is any conflict in the information provided. While economic, business and population demographics may cause some incidental degree of similarity in the geographical locations of SBIC and private venture firm investments, we are convinced that an in-depth comparative analysis of the investments by these two industries will show a significantly greater geographic dispersion of SBIC investments.

Similarly, while NASBIC and SBA data provided in connection with the 1985 authorization hearings placed some degreee of emphasis on high tech statistics to make a specific point for those hearings, we are convinced that a detailed comparative analysis of the types of investments made by SBICs and private venture firms will conclusively show a far higher concentration of private venture firm investments in a narrow category of high technology fields.

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